APRIL 2018 MARKET COMMENTARY

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

April Showers, May Flowers?

“Though April showers may come your way
They bring the flowers that bloom in May
So if it's raining have no regrets
Because it isn't raining rain you know, it's raining violets

And where you see clouds upon the hills
You soon will see crowds of daffodils
So keep on looking for a blue bird
And list'ning for his song
Whenever April showers come along”

(*“April Showers”, performed by Al Jolson, written by Louis Silvers and B.G. Deslyva*)

Unlike here on the West Coast, spring is taking its sweet time arriving on the East Coast of the US – much of April was cold and wet. There were several “head fakes” – days when the temperatures rose and the rains dried up. But just when it seemed safe to put away the winter coat, another cold front would blow through and the cycle would start again.

Frustrating, but perhaps a fitting weather pattern for the current global economy and investment markets. There are a variety of positive signs – fairly steady GDP growth, high consumer and small business owner optimism, rising wages, falling unemployment, and strong corporate earnings.

But there are some clouds out on the horizon – a flat US yield curve, increasing short-term rates (specifically an increasing “LIBOR-Overnight Indexed Swap (OIS) Spread”, suggesting that bank’s willingness to lend is declining), positive but slowing manufacturing, generally weakening economic data, and inflation threatening to do more than just threaten.

It is important to remember that that the market is a *discounting* mechanism – what is happening right now is less important to current market levels than what the market expects to happen in the future – and therefore discounts or prices in today. This explains why the markets remain volatile and generally flat despite current economic strength and strong corporate earnings.

Specifically, as the market looks into Q3 and Q4 of 2018, as well as into 2019, it sees slowing economic growth (though recession still seems a ways away), slowing earnings growth, rising inflation, rising interest rates, and a gradual withdrawal of global central bank liquidity. Right now, we seem to be at an inflection point as strong earnings (a catalyst for rising stock prices) battle against rising interest rates (generally a catalyst for declining stock prices).

We are on record as indicating that we do not believe inflation is as worrisome as some market analysts suggest, and we stand by that, but it *is* increasing, specifically as the result of wage increases. In addition, while the recent tax law changes are decidedly stimulative to US economic activity, they are also decidedly negative with respect to US federal deficits and debt, and increased US Treasury borrowing could provide further impetus to the general upward pressure in interest rates.

The flatness of the yield curve (less than 50 bps between the 2-year and 10-year Treasury rate as of late April) also has some analysts concerned – an inverted yield curve (where long-term rates are lower than short-term rates) has frequently (but not always) been a precursor to economic recession.

There are signs that the long end of the curve has begun to grind higher from current levels as inflation picks up. As with our view on inflation, we are on record as stating we believe the yield curve will *not* invert. We also take some comfort from the fact that, should we be proven wrong, history suggests that any economic recession that may follow an inversion (and remember, it does not *guarantee* a recession) typically lags such an inversion by 12-18 months. In other words, we are not convinced the yield curve *will* invert, *should* it invert we are not convinced it signals an impending recession (since there are certain technical and investment flow issues that are working to keep the long end down – not just declining economic conditions), and if it *does* signal an impending recession, we should have time to prepare.

With that as a backdrop, here is what we see in the current economic and investment landscapes.

The Current Economic Landscape

Despite significant recent market volatility, the global economy remains solidly positive right now:

- Estimates for US Q1 GDP growth are 2.1% (down from earlier estimates). GDP growth is expected to accelerate through Q2 (3.2%) and Q3 (3.1%) before slowing in Q4 (2.9%), bringing the consensus estimate for all of 2018 to 2.8% (source: *The Wall Street Journal*);
- There is uncertainty regarding this forecast, however, as the ultimate impact of the tax law changes and the outcome of ongoing trade negotiations could dramatically change the economic outlook for the US over the remainder of the year;
- Both the US manufacturing and services sectors remain well in expansionary mode (59.3 and 58.8 in March, respectively; any reading above 50 is considered expansionary), though both have posted month-over-month declines in the past 2-3 months (source: *ISM*);
- Inflation (as measured by CPI) rose 2.4% year-over-year in March, in line with market expectations and tracking slightly above the Fed target of 2.0% (source: *TradingEconomics*). We believe inflation will continue to tick up but that it does not yet constitute a primary risk to economic growth;
- The consensus estimates are that the Fed will raise rates 2-3 more times in 2018, following the widely anticipated 25 bps hike in mid-March;
- Interest rates seem to have begun what we expect to be a “grind higher” regime, with the 10-year Treasury rate recently breaking through the mental barrier level of 3.0%. As with inflation, we do not see rising rates as posing a significant threat to economic growth – at least for a while;
- The yield curve remains flat as the Fed raises rates on the short-end but the long end remains somewhat “tamped down” by steady demand, expectations for an eventually slowing economy, and moderate (though accelerating) inflation trends. Despite rising short-term rates, we continue to believe the yield curve will not invert;

- The US dollar, after weakening through the first quarter; strengthened over most of April as the US economy, interest rates, and inflation all picked up steam (source: *TradingEconomics*);
- With more than 150 US companies having reported so far, first quarter earnings are up a whopping 25.4% year-over-year, on a 10.3% increase in revenues. Expectations for all of Q1 are for an overall increase in earnings of roughly 20% on an 8% increase in revenues (source: *Zachs Earnings Report*);
- Manufacturing all across the Eurozone remains solidly expansionary, with the Markit manufacturing index falling slightly from 56.6 in March to 56.0 in April. Likewise, the Services index fell slightly from 55.0 in March to 54.9 in April (source: *TradingEconomics*);
- Eurozone unemployment fell to 8.5% in February, down from 8.6% in January – a 9-year low, and annualized inflation through March came in at 1.3%, up slightly from February. 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. Expectations are that he will begin some level of tapering perhaps as soon as September of this year;
- 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% (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 saw (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);***
- ***The US dollar remained weak through the first quarter, though it strengthened through most of April. We believe going forward that an expanding US economy, rising inflation rates, and continued tightening of Fed policy will stabilize or strengthen the dollar;***
- ***Inflation is a question mark, and definitely is trending higher, but we don't share the market's overall level of concern. Inflation will continue to 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;***
- ***We remain in somewhat "uncharted waters" from an economic policy perspective, as the US seems intent on piling on fiscal stimulus with already expanding economy – it is working, but the inflationary and deficit impacts may have significantly 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 market turbulence and investor uncertainty, solid GDP growth and solid earnings and revenue growth, combined with slowly rising interest rates, make for a generally positive market environment, and we still think stocks can 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;***
- ***Market volatility will remain elevated as interest rates grind higher – this should accordingly be a better environment for active managers;***
- ***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;***
- ***The US yield curve remains 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 should be reasonably safe as corporate balance sheets are in good shape;***
- ***Global commodity supply continues to generally exceed demand, though oil prices have picked up due to unrest on the Middle East and voluntary supply cuts by several OPEC nations;***
- ***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.***

Spring has finally arrived, and we can look forward to warmer days and the belated enjoyment of traditional spring blossoming and growth. This seems as true for the global economy and investment markets as it does for nature.

But, like the *Aesop* fable of the ant and the grasshopper, we encourage investors to think and plan ahead for the colder months that will eventually follow – perhaps as soon as Q3 or Q4 of this year, but almost certainly sometime in 2019.