2018 First Quarter Commentary and Outlook

Forces at Play

The Narrative

In the first four weeks of the year the S&P 500 surged 7.5% in anticipation of continued economic growth supported by the recently enacted tax legislation and the prospects of increased government infrastructure expenditures. However, the market then abruptly reversed course, giving back the preceding weeks' gains and then some. Throughout the remainder of the quarter when valuations became more attractive, investors drove share prices higher only to have share prices subsequently pull back. Whether first quarter patterns were attributable to short-term data sound bites sparking investor concerns over inflation and higher interest rates, uncertainty as to Federal Reserve Bank Policy, political polarization impeding legislative initiatives, or Trade policy, the fits and starts of the equity market were extraordinary and violent. Internationally, equity markets in the developed world experienced much the same pattern although emerging markets ended the quarter with a small gain.

The Dow Jones Industrial Average, S&P 500, Russell 1000, Wilshire 5000, and S&P 400 Mid Cap Index all declined in the first quarter of 2018 (-1.96%, -.76%, -.69%, -.76%, and -.77%, respectively). The Russell 2000 Small Cap Index lost -.08%. Only the NASDAQ was positive for the quarter (+2.59%), as technology shares held on to some of their earlier gains.

Both the MSCI All Country World Index and the MSCI European Equity Index declined -.96% and -1.98%, respectively. These returns reflect currency conversion gains, as the US dollar declined during the quarter. The MSCI Emerging Markets Index rose 1.42% for the quarter.

At the close of the quarter, the price-earnings ratio of the S&P 500 was approximately 16.9x analyst consensus earnings estimates for calendar year 2018 and 15.3x S&P estimated operating earnings for 2019, reflecting anticipated earnings growth in 2018 enhanced by corporate tax reform of 18.6% (17% estimated year-over-year for the first quarter) and 10% year-over-year growth for 2019.

A price-earnings ratio of 16.9x implies a corporate bond interest rate of nearly 6%, yet the BBB corporate investment grade long-term bond (which now comprises approximately 50% of the investment grade corporate bond universe) is currently yielding approximately 4.6%. While investors often look to the bond market for signals regarding equity valuations, it appears that given the many uncertainties that are encircling the capital markets, it is equities that are signaling relative valuation concerns. Interest rates remain weighed down by years of Federal Reserve policy that collapsed corporate credit spreads (the additional interest rates in excess of comparable term US Treasury securities) that have thus far been more resistant to expansion than equity multiples have been to contraction when confronted by many uncertainties and policy inflection points. It is these uncertainties that have produced the excessive volatility of the past 3 months, rather than a shift in the economic or corporate earnings fundamentals.

In the days after the close of the quarter, the volatility continued and was amplified by proposals of trade tariffs, and escalating trade tensions with China, the world's second largest economy.

The Economy

The consensus view, supported by the Federal Reserve, is that the domestic economy is stable and growing 2.7-3% per annum and employment is solid, and that while there have been some data points that presage early signs of inflation, "organic" inflation is not presently a heightened concern. Internationally, European and Asian economies continue to trend positive (albeit at a recently slowing pace) with continued support from central banks. Looking forward, however, investors are now focusing on the structural and policy forces that impact markets as summarized below.

Forces at Play

Share buybacks funded by corporate leverage have proliferated for several years, supporting equity markets by amplifying earnings per share by distributing earnings over fewer shares outstanding. Equity markets have now taken note of the increased debt outstanding and potentially widening credit spreads. A significant rise in corporate interest rates resulting from wider spreads or more restrictive Federal Reserve policies would negatively impact corporate earnings.

Inflation fears continue to capture the attention of bond and equity investors alike. Oil and gasoline prices have recently begun to rise in response to production cuts, and after several years of economic growth, increased labor force participation and low unemployment, excess production capacity has lessened. Recent wage increases, though moderate, have put this metric on investors' inflation watch radar. Beginnings of worker shortages have been reported that could contribute to further wage demands. Immigration policy does not appear to be sympathetic to assuaging this need. Imports that generally temper inflation may no longer be as efficacious if tariffs materialize and free trade deals dissolve. For now, however, inflation is seemingly benign.

As a result of positive consumer sentiment, consumer debt has risen. A sharp rise in interest rates would negatively impact consumer demand.

The Federal Reserve's announced policy of interest rate increases remains data dependent and cautious. Nevertheless, there is a perceived bias toward raising in order to reload policy tools for the future. Even as the Fed raises rates and allows its balance sheet to gradually unwind, external market forces hold down interest rates. Both the European Central Bank and the Bank of Japan are still engaged in quantitative easing operations, maintaining lower local interest rates that incentivize capital to flow to higher yielding U.S. securities, increasing demand and tempering U.S. rates.

Fiscal Stimulus is strongly positive for corporate earnings and arrived in the form of corporate tax cuts, increased government spending, and the promise of a yet to be enacted infrastructure program. Both fiscal deficits and trade deficits that contribute to a strong economy necessitate increased levels of treasury debt issuance. This swells the debt supply in excess of current demand and pressures interest rates to rise so as to attract investors. Interest rate pressures such as this, even as equity markets decline, lessen the hedging effects that bonds may add in a balanced portfolio.

Tariffs that impede international trade are generally thought to have a slowing effect on the world economy - slowing cross border demand, affecting relative currency values, artificially raising inflation, reigning in consumption and delaying corporate investment. It seems to us that it is unrealistic to believe that overall U.S. trade deficits will materially be reduced by tariffs or by dissolving free trade agreements without resulting in significant economic harm (including job losses in export related industries and disruption of the global supply chain). It could also prompt retaliation by China including further obstruction of foreign company operations in China, reduction of its investment in the U.S. and in U.S. treasury securities, withdrawal of its diplomatic assistance in North Korea and an increased military presence in Asia.

It is estimated that $150 billion of trade (representing goods that may become subject to tariffs) with China represents approximately 8/10ths of 1% of U. S. GDP. Significant, though not catastrophic. Some have also observed that March's lower than expected job creation may in part be attributable to fears of a trade war.

Although there is agreement that China has behaved unfairly in violation of international trade laws and has engaged in unfair practices regarding intellectual property, it seems to us unlikely that overall trade deficits will dramatically be slashed by the implementation of trade tariffs, as capital will seek its best return and lowest cost absent artificial restrictions. As long as there are countries with a lower standard of living and lower cost structure than the U.S., they will attract capital and thereby redistribute trade deficits from targeted tariff countries. The threat of tariffs, however, may be a catalyst for reforming these unfair practices.

In recent developments, continued data breaches at retail and financial companies have, together with the revelation of the use by bad actors of Facebook subscribers' personal data in targeted issue-related advertising and "news feeds", rocked technology companies where use of such data is integral to their business model. Investor concern over both potential regulation that will adversely impact growth and customer defection have impacted social media and technology shares.

Finally, geopolitical risk remains heightened. Russian relations with the U.S. and Europe have deteriorated, North Korean-U.S. tensions escalated (until the recently announced agreement to engage in direct negotiations), and the use of chemical weapons in Syria has increased tensions in the Middle East and between the U.S., Europe, and Israel on the one hand and Russia and Iran (the supporters of the Syrian regime) on the other. These, as well as the ongoing threats and counter threats of tariff warfare between China and the U.S. have all added to capital market volatility and concerns during the past several months.

The fundamentals supporting continued economic growth and earnings growth remain but will continue to be challenged by the uncertainties that abound.

Portfolio Construction

We continue to maintain a substantial equity allocation in most client portfolios, as domestic economic conditions and worldwide economic growth are supportive of corporate earnings and further equity gains.

We continue to have a meaningful allocation to fixed income securities (principally municipal bonds) in most client portfolios. We have acted to shorten duration (sensitivity to rising interest rates) and capture higher money market yields. We note, however, that as interest rates rose during the quarter, bond portfolios (though considerably less volatile than equities) declined but, nonetheless hedged against equity risk.

Finally, equity valuations have been tempered by share price retrenchment and investor caution attributable to the uncertainties outlined above. We view a substantial allocation to equities as an important driver of future portfolio returns.

Now we await corporate earnings reports…

April 10, 2018

The above commentary represents the economic and market views of our firm. We remind you, however, that each client's portfolio is managed individually. Please speak with your KLS advisor with respect to your personal circumstances and individual portfolio performance.