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Investment and Financial Consultants

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FIRST QUARTER 2018 ECONOMIC AND FINANCIAL MARKETS REVIEW

After a calm uptrend last year, the stock market turned volatile during the first quarter of 2018. The initial trigger for the sharp stock market decline that began in February was a strong employment report that showed the largest increase in average hourly wages since the Great Recession. This report led to fears that wage inflation could lead to rapidly rising interest rates in the bond market, which could harm the economy. Several weeks later, the Trump administration announced tariffs on steel and aluminum, which created fears of potential trade wars. Tariffs and ensuing trade wars can also lead to inflation because they typically result in a rise in the cost of raw materials and products. The reason inflation typically leads to rising interest rates is because investors will demand higher yields on fixed income investments to keep up with rising costs for goods and services. Investors are also concerned that the Federal Reserve Board will need to raise interest rates more aggressively than initially anticipated this year to slow these inflationary forces. Due to these concerns, the S&P 500 Index finished the first quarter down 1.22% while the Dow Jones Industrial Average fell 2.49%. Due to rising interest rates, bonds mostly declined during the first quarter. For example, the Bloomberg Barclays Bond U.S. Intermediate Government/Credit Index lost .98% during the first quarter of this year.*

Rising interest rates can be a negative for stocks for two reasons. First, rising rates increase the cost of borrowing for consumers, corporations, and governments, which weighs on economic growth and corporate profits. The Federal Reserve Board purposely lowered interest rates to near-zero during the financial crisis to reduce the cost of borrowing in an attempt to help grow the economy. Now, if interest rates rise too rapidly, it could harm economic growth just as the global economy is gaining traction. Secondly, as interest rates rise, yields on fixed income investments, such as bonds and CDs, become more attractive. This leads investors to consider reallocating funds out of stocks into potentially more stable and higher-yielding fixed income investments.

In addition to rising interest rates, significant stock market gains with little volatility last year made investors extremely complacent and numb to stock market risks. Important measures of investor sentiment showed optimism toward stocks reached historic highs at the beginning of this year. Many times when investors become too optimistic, the market becomes overvalued and declines quickly at the first sign of trouble. If investor sentiment becomes too exuberant again, stock market prices will likely correct at another time this year.

Despite the increase in volatility and concerns regarding inflation, rising interest rates, and excessive investor optimism, we are not expecting that these issues will lead to a long-term bear market at this time. The first quarter market correction reduced excessive optimism towards stocks and brought prices down to more reasonable valuations. Stock market corrections typically occur over days or weeks, are caused by excessive speculation, and are triggered by acute news events. Conversely, bear markets typically last months or years and are typically caused by structural economic problems. Because there do not appear to be any major economic problems on the horizon, it is quite possible that 2018 will still be a positive year for stocks. A longer-lasting market decline will become more of a concern if the economy begins to weaken, leading to lower corporate earnings. It would be very rare for a bear market decline of 20% or more to begin right now while the global economy and corporate earnings have been strengthening. Furthermore, we do not expect interest rates to rise so rapidly that their rise will create a recession this year. That said, rising interest rates accompanied by rising debt levels among consumers and the federal government could eventually create a fiscal crisis that could be the cause of the next significant bear market down the road.

Due to the robust global recovery, growing corporate earnings, and relatively low risk of a significant bear market occurring in the near-term, we recommend using short-term stock market weakness to increase exposure to equities for certain risk-tolerant investors. We continue to prefer investing in large U.S. companies that sell products and services overseas. These companies benefit from the strengthening global recovery. We also continue to like the idea of allocating additional funds to foreign stocks that stand to benefit from the global economic recovery. Within the fixed income arena, we continue to favor short-term bonds over intermediate-term and long-term bonds. Short-term bonds are less sensitive to rising inflation and rising interest rates, which can negatively impact bond prices.

As always, we will continue to monitor economic, interest rate, and financial market conditions in case the economic and corporate profit outlook changes. In the meantime, please contact us if you have any questions or concerns regarding the financial markets.

* *Index returns were obtained from the Wall St. Journal and Bloomberg Barclays on March 30, 2018.*