Insights: April 2018

Market Overview and Performance

If you read our Insights letter last month, the themes dominating April's offering will sound very familiar. In March, we discussed only two general trends – a spike in volatility and the threat of damaging trade wars. Both of these narratives continue to dominate investor attention and unfortunately, the situation has only gotten worse in both arenas. According to the Wall Street Journal's Daily Shot column, the average daily trading range for the S&P 500 over the past 50 days has exploded to 1.6 percent, meaning that the difference between the high and low on each trading day has grown to close to two percent. That is an enormous number and harkens back to the ugly days of 2009. However, more worrisome by far is the escalation of the trade war threats between the U.S. and China. Speaking at the Boao Forum for Asia this week, Christine Lagarde, the Head of the International Monetary Fund, expressed the world's growing concern. "The multilateral trade system has transformed our world over the past generation. But that system of rules and shared responsibility is now in danger of being torn apart. This would be an inexcusable, collective policy failure." As we discussed last month, in isolation, trade wars are always detrimental to economic growth and act as a tax on consumers. However, the barriers being discussed come at a particularly sensitive time as global growth is noticeably slowing and the U.S. is faced with the very real challenge of funding its exploding debt in the face of rising interest rates. As we said last month, stagflation, or rising inflation without economic growth, is becoming a true concern.

As always, thank you for reading our latest Insights.

	Month to Date	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	-2.54	-0.76
Russell 2000 Index	**1.29**	-0.08
MSCI EAFE Index	-1.80	-1.53
MSCI Emerging Markets Index	-1.86	**1.42**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	0.64	-1.46
Barclay's U.S. Aggregate Credit Index	0.75	**-3.83**
Barclay's U.S. Aggregate Corporate High Yield Index	-0.60	-0.86
Barclay's Municipal Bond Index	-0.30	-1.47
Macro Measures		
Gold	0.71	1.36
Crude Oil	**5.08**	6.96
CBOE Volatility Index	0.60	**44.72**
USD Dollar Index	-0.51	-2.19

Current Theme – More of the Same, Only Worse - Market Volatility Comes Back with a Vengeance and is Likely to Persist – Are Trade Tariffs Ushering in a Period of Stagflation?

Misguided Trade Tariffs and the Potential for Resulting Trade Wars Threaten the Global Growth Regime

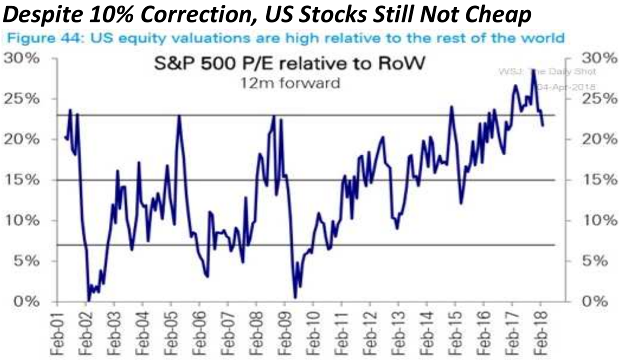
While the current investment environment feels quite shaky and fickle based upon whatever happens to be the biggest headline of the day, not that much has really been achieved. As you can see below, the S&P experienced a sharp run-up in January, then reversed in February and bounced back around the bottom through much of March.

Stocks Were Volatile in Q1 But Made Very Little Progress

Source: Thomson One

At the end of the day, we ended March very close to where 2018 began. And unfortunately, the 10 percent move lower did very little to combat the impressive move higher since 2016. In fact, S&P 500 stocks remain quite expensive relative to their counterparts from elsewhere around the globe.

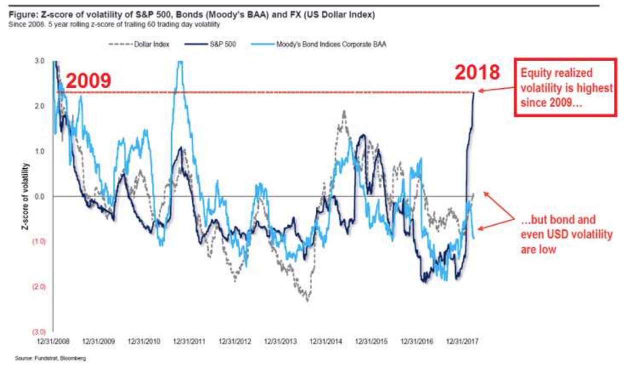
Despite 10% Correction, US Stocks Still Not Cheap



Source: WSJ; IBES; Factset; Deutsche Bank

Although 10 percent corrections are to be expected from time to time, one significant change that we have seen in 2018 has been the astounding spike in volatility. As we mentioned in our opening comments, the average daily trading range of the S&P 500 is now 1.6 percent which means the realized volatility is now as high as it was in 2009 according to Tom Lee at FundStrat. This is not just level of the CBOE VIX Index which many suggest is still fairly tame, it is a reflection of what investors are actually experiencing.

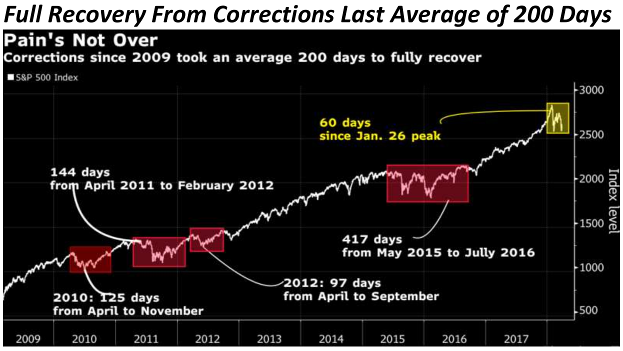
Realized Volatility Over Last 60 Days Highest Since 2009



Source: FundStrat; Bloomberg

And hope as one might, this volatility is not likely to end anytime soon. As Bloomberg has shown in the chart below, corrections since the Global Financial Crisis in 2008 have averaged a decline of roughly 14 percent and have taken around 200 days to fully recover. We are only about 60 days from the peak at the end of January. Looking back even further to 1929, Deutsche Bank has found that high volatility periods have on average taken 60 trading days (that's about three months) *just to find a true bottom*, much less recover.

Full Recovery From Corrections Last Average of 200 Days



Source: Bloomberg

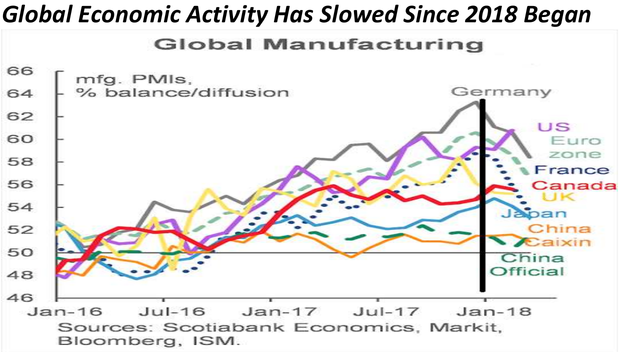
With that in mind, one of the areas outside of the political realm that could prolong the turbulence is earnings growth. With the passage of tax cuts, analysts have sharply raised their estimates for growth to 21 percent for 2018. That is quite high by historical standards. As one can see below, annual estimates typically start around 12 percent and ratchet down as the year progresses.

2018 Earnings Expectations Are Looking too Optimistic?

Source: Bianco Research; Bloomberg

Even if we get a one-time tax bump, many corporate officers from across industries have already commented that they are tapping the brakes somewhat in light of potential trade wars and rising inflation which would simultaneously decrease their revenues and increase their cost of doing business. Unfortunately, we have already seen signs of activity being curtailed. As you can see below, global manufacturing looks to have peaked at the start of 2018. There are other measures showing similar trends, but the key here is that we are seeing disappointing growth data across the globe and not just in one region. Clearly, this is not a good environment to be implementing trade tariffs and protectionist policies.

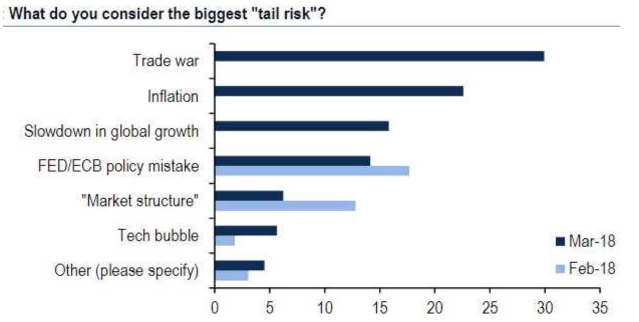
Global Economic Activity Has Slowed Since 2018 Began



Source: WSJ; Scotiabank; Markit; Bloomberg; ISM

The earnings calls this quarter will be important. As Merrill Lynch has found in their most recent Global Fund Managers Survey, investors are extremely concerned with the triple threat of trade wars, inflation and a slowdown in global growth.

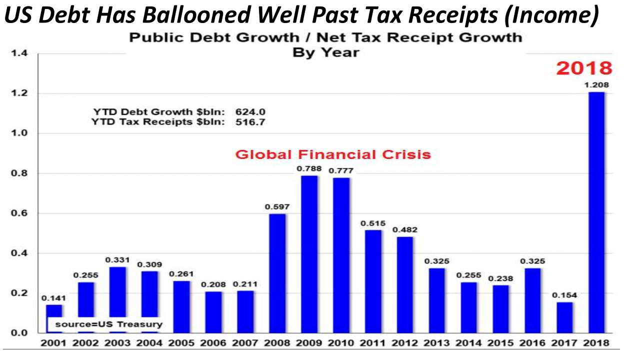
Trade Wars, Inflation and Slowing Growth Now Big Risks



Source: BofA Merrill Lynch Global Fund Manager Survey

Even if one puts aside all the rhetoric about trade wars and assumes that they never come to pass, we have the unfortunate truth that the U.S. has put itself in a difficult position. As a result of the recent spending and tax cut package passed by Congress, so far in 2018, debt growth is far outpacing tax receipt growth. As the chart below from the U.S. Treasury shows, debt has grown by $624 billion while tax receipts have only grown by $516 billion. This is well above the ratio of debt to income seen over the last 20 years including during the Global Financial Crisis when emergency measures were put into place to stabilize the system.

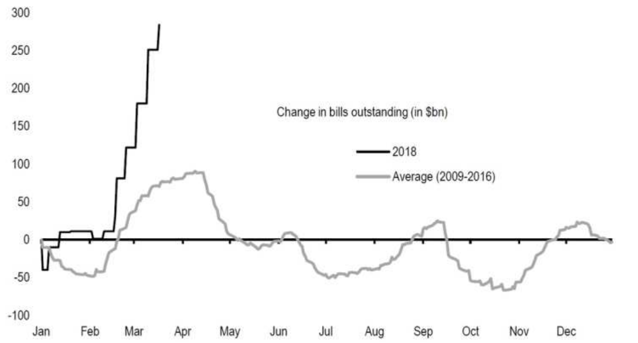
US Debt Has Ballooned Well Past Tax Receipts (Income)



Source: Unites States Treasury

As a consequence, the U.S. now has little choice other than to fund itself by selling even more debt. The following chart speaks for itself. This number is set to approach $1 *trillion* this year and exceed $1 trillion in each of the following two fiscal years.

US Ramp Up in Debt Issuance Began in Earnest in March



Source: Credit Suisse Research

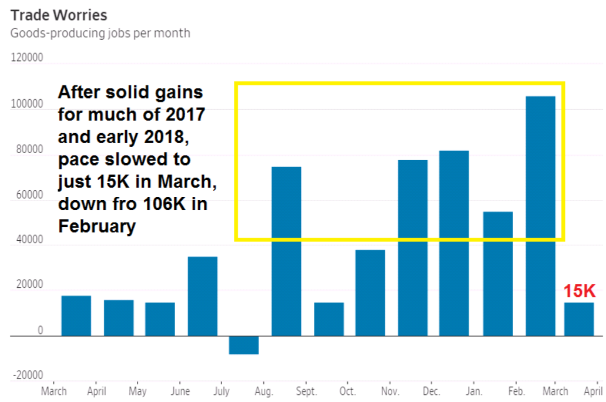
And there is little doubt that the U.S. relies on other countries to purchase its bonds. As you can see below, China and Japan together hold about 40 percent of all the foreign holdings of U.S. debt securities. The U.S. simply cannot afford to jeopardize the demand from these buyers.

China's Holdings in US Treasuries Remains Substantial

Source: Bloomberg

A cynic looking at this chart would suggest that foreign holders are already starting to taper their purchases in 2018. That remains unclear, but China's ambassador to the U.S. would not rule out the possibility of China scaling back its purchases of Treasuries in response to tariff proposals, stating "We are looking at all options". And perhaps they are laying the groundwork for this tactic when their rating agency downgraded its U.S. debt rating on April 5th. In fact, China holds quite a lot of cards to play in its poker match with the U.S. There are some concrete measures they can take, but there are also more subtle posturing maneuvers that can have real impact. And they already have. On April 6th, the Ministry of Commerce stated, "We feel America is very arrogant. They have taken a wrong action. The result is that they will hurt themselves. If they release the list of $100 billion tariffs, China is prepared. And will not hesitate. We will immediately fight back with a major response." Words have consequences unfortunately and market participants will take action to re-position even before any real policies are enacted. Consider the following recent contraction in goods manufacturing jobs. Uncertainty curtails hiring plans.

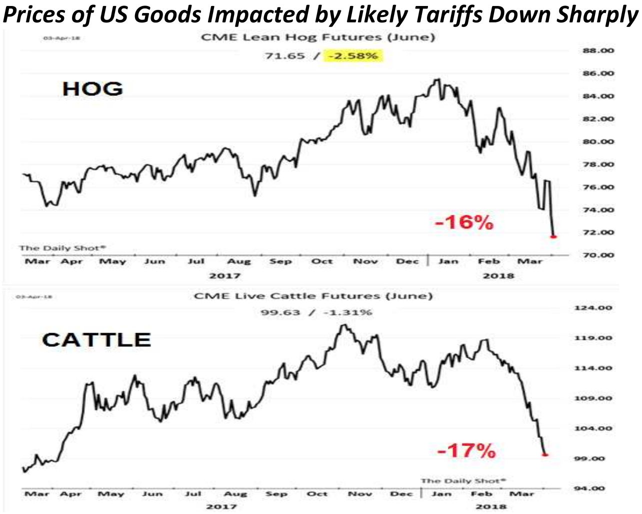
Goods Manufacturing Jobs Slowed Notably in March



Source: Wall Street Journal

And perhaps even more directly, the price of hogs and cattle, two very important U.S. exports to China, fell by over 16 percent. This is a real negative impact on the people who produce and sell those goods.

Prices of US Goods Impacted by Likely Tariffs Down Sharply

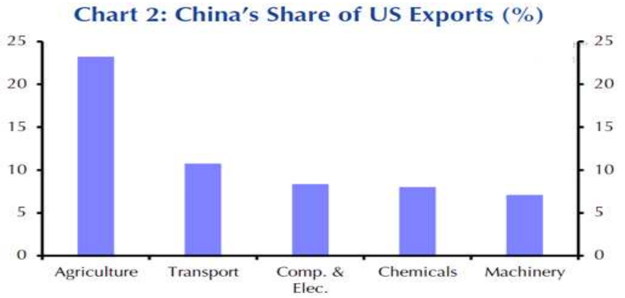


Source: BoAML Global Research

A simplistic view here would look at the numbers and say, "Wait a minute, China sells us $500 billion goods and we only sell them $150 – they need us a lot more".

We discussed trade deficits at length last month, but there is a lot more to trade than just balances. As High Frequency Economics wrote last week, China knows they are important to U.S. trade as seen below.

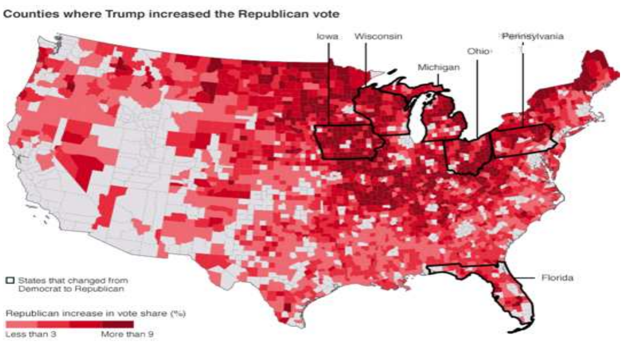
China Is In Fact An Important Trade Partner for the US



Source: Census Bureau

Further, China "has little to fear" in their view. "While China's exports to the U.S. are 18% of global exports, the $150 billion of total sales to the U.S. that would be subject to tariffs are only 6.5% of its $2.3 trillion in total export sales. If they were to lose half of those sales due to tariffs, the 3.25% loss would hardly be noticed." They doubt even that small loss would occur, "most of what China exports to the U.S. has no domestic substitute. That means U.S. consumers will just pay more to buy the same stuff. In contrast, China can find alternate suppliers for almost everything." China is also keenly aware that Trump has to keep voter support in mind. Most of the goods China has named in their retaliatory tariffs are concentrated in regions that were key to Trump's election victory. The Brookings Institute looked at all those products China threatened and found that they would affect about 2.1 million jobs spread across 2800 counties of which 82 percent voted for Trump.

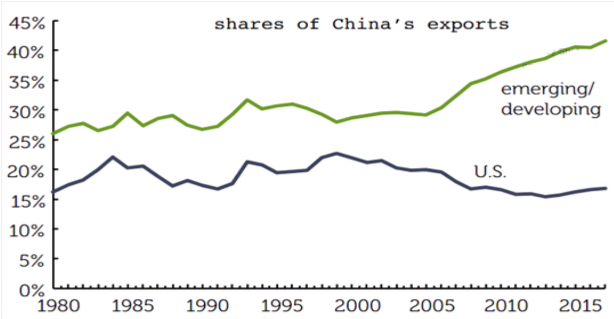
China Tariffs Target Areas of Past Trump Support



Source: Wall Street Journal; BBC

China has no such obligation to keep voters happy or to even go through a legislative progress before enacting policy changes. They also happen to have $3 trillion lying around in cash reserves, which they can use to subsidize any area of their economy that may feel some pain from the trade war as they did in 2008 and 2009. They can also easily make business conditions in China very difficult for large leading U.S. companies like Apple, Nike, Boeing, Intel, etc. This could all be accomplished while portraying themselves as the "victim" in the scenario with little pushback. In the meantime, China is already very focused on looking ahead with its "Made in China 2025" imitative. As you can see below, the U.S. is no longer the focus.

China Sees Future of Growth Coming From Outside US



Source: WSJ The Daily Shot

Additionally, China is working hard to make progress on its "Belt and Road" initiative to establish modern trade routes connecting Asia, Africa and Europe.

China is Already Building its Future Around Europe and Asia

Source: CSIS Reconnecting Asia Project

So how do you "win" a trade war? China has reportedly offered $50 billion in trade deficit reduction through the purchase of more liquid natural gas and semiconductors. Some may view that as a win, but in reality, "Made in China 2025" will not have been slowed down by any measure at all.

Going Forward

As the first quarter of 2018 comes to a close, the tepid environment and optimism of 2017 feels long gone. International relations, be it in Asia or Syria, and Trump's unpredictable behavior have evolved into a much more significant set of risks. As we stated previously, the stock market price correction in February and March was certainly not unexpected in our view and was justified. However, with index levels still not far off their all time highs, we view the heightened degree of uncertainty surrounding the global growth environment instigated by the Trump trade tariffs as significantly increasing the amount of risk. This is not just a valuation or technical concern, but rather, it is a view that the positive fundamentals may now be impeded. Our hope is that this turns out not to be the case.

Assuming a benign environment for the time being, within US equities, we favor the information technology, financial and energy sectors in particular and added to these areas on a selective basis during the correction we just experienced. The technology sector continues to display very strong growth and profitability. Financial names are still reasonably priced and will benefit from a raising rate environment and a reduction in their tax rates. The energy sector is recovering from a significant decline in the summer of 2017 and the tensions in the Middle East fueled by threats of missile launches in Syria, are serving to push prices even higher. Energy stocks were hit particularly hard during the first quarter sell-off, providing compelling entry points. We also look to selected industrial and material names to outperform in 2018 as the demand dynamics and global growth look to be a tailwind for 2018 under the current non-trade war scenario.

With the potential damage to global trade that tariffs represent, domestically focused small and mid cap stocks have become more attractive in our view. Small cap stocks in the Russell 2000 Index experienced considerable multiple compression during the sell-off making their valuation levels compelling versus their large cap counterparts. Importantly, smaller non-global companies are generally less impacted by trade tariffs, making them a good counterbalance to internationally exposed companies when revenue streams from abroad are in question. We saw evidence of their benefits during March when the Russell 2000 outperformed the S&P 500 by almost 4 percent.

Particularly in light of a protectionism stance here in the U.S., equity markets outside of the US are compelling in our view. After years of lagging the US market, International equities now display faster economic growth than the U.S., combined with reasonable valuation levels and stimulative fiscal policies. Europe and Japan in particular are attractive in our view. With regard to emerging markets, we also see long-term opportunity. As a group they are demonstrating strong profit growth, improved balance sheet stability, and very attractive valuation levels. Significantly however, emerging markets are perhaps most susceptible to interruptions in global trade so we remain vigilant.

Our biggest concern in the fixed income market has again rotated back to the flattening yield curve. The yield curve is at its lowest level since 2007, the bond market is suggesting that apprehensions about future growth are very real. Additionally, the supply of bonds this year will be substantial, pushing yields even higher. As a result, we continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We continue to focus our exposure on municipal bonds and short-term corporate bonds and believe that the opportunity in these segments provides a better relative value.

Given the continued unsettled environment thus far in 2018, we have maintained a position in gold in many of our portfolios as a non-correlated asset and continue to do so, adding when appropriate. Until there is more clarity on the global macro trajectory, we are likely to add opportunistically.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.