Insights: March 2018

Market Overview and Performance

Well, 2018 is certainly off to quite a start. Just as was the case in January, we sat down in the early days of February to collect our thoughts about the events and trends of the month, when suddenly in the last week, the environment and narrative changed completely. Last month we wrote about how the market had over-extrapolated a risk asset friendly backdrop resulting in stock prices moving well ahead of where they should be. We further suggested that rising bond yields and heightened concerns about increasing inflation risks initiated a fairly orderly and justified price correction from the peak on January 26th. In February, the market appeared to digest these evolutions with an undeniable increase in price volatility but without any "panicky" irrational moves. And in fact, there was reason to believe that everything was generally working out fine, particularly with corporate earnings continuing to deliver impressive results. Yet once again, in the final days of the month, the trend was clearly derailed yet again. As Blaine Rollins at 361 Research wrote, "The week started with a white-hot U.S. economy, rising interest rates and expectations for some new gun control laws in Washington. But somehow the week entered a prism and we ended up with a global trade war and expectations for continued economic growth being shot in the foot." This is a serious concern since tariffs and trade wars, unlike 10 percent price corrections, severely impact the fundamental ability of the global economy to function properly. Stagflation it seems – rising inflation combined with stagnant economic growth – could be on the horizon.

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	-3.69	1.83
Russell 2000 Index	-3.87	-1.36
MSCI EAFE Index	-4.51	0.28
MSCI Emerging Markets Index	**-4.61**	**3.34**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.95	-2.09
Barclay's U.S. Aggregate Credit Index	**-3.31**	**-4.54**
Barclay's U.S. Aggregate Corporate High Yield Index	-0.85	-0.26
Barclay's Municipal Bond Index	-0.30	-1.47
Macro Measures		
Gold	-1.91	0.65
Crude Oil	-5.01	1.98
CBOE Volatility Index	**31.79**	**44.38**
USD Dollar Index	1.63	-1.67

Current Theme – 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

Well, that escalated quickly as they say. After an irrationally exuberant January punctuated by a new all-time high of over 2800 on January 26th, the S&P 500 declined by 10 percent over the following 9 trading days. That is the fastest 10 percent correction from all time highs on record according to senior strategist Ryan Detrick at LPL Financial.

S&P 500 Fell -10% From January High Before Rallying

Source: Thomson One

As we have discussed, the initial sell-off can generally be attributed to concerns over spiking bond yields and inflation measures, however, as you can see in the chart above, the realization that nothing had materially changed brought buyers back in by mid month. The resurgence did not last long however, with the market being whipsawed between overbought to oversold and back again within a matter of days.

No Stability in Markets Quite Yet – Sharp Moves +/-

Source: Bespoke Investment Group

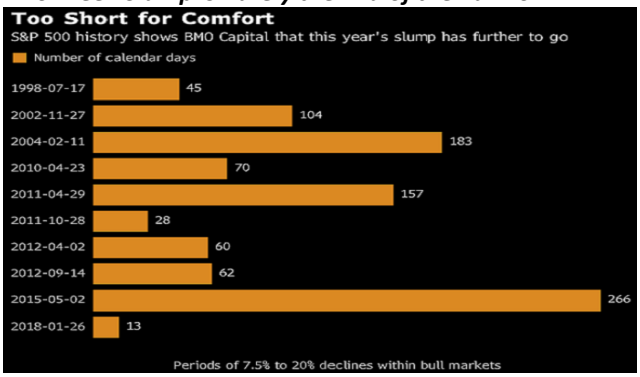
This suggests that it is not a time to simply, "buy the dip". In fact, as you can see in the chart below, while volatility was compressed to abnormal levels last year, today's volatility is somewhat of an outlier. Bloomberg calculates that as long as we assume we are still in Bull market phase, this is the most volatile period outside of the US debt downgrade in 2011. 36 percent of trading days this year have seen a move of at least +/- 1 percent.

Daily Volatility High and Rising: 36% of Trade Days +/-1%

Source: Bloomberg

And for those who might say this is an overreaction, consider the chart below from BMO Capital markets. Once again assuming we are still in a Bull market, the length of a drawdown period has historically been much longer than a few weeks. At a minimum, these episodes generally take around 60 days or more to work themselves out. This is five times longer than what we have just experienced in February. This is normal. What was not normal was the market rattling off month after month of positive gains over the last year and half or so, uninterruptedly.

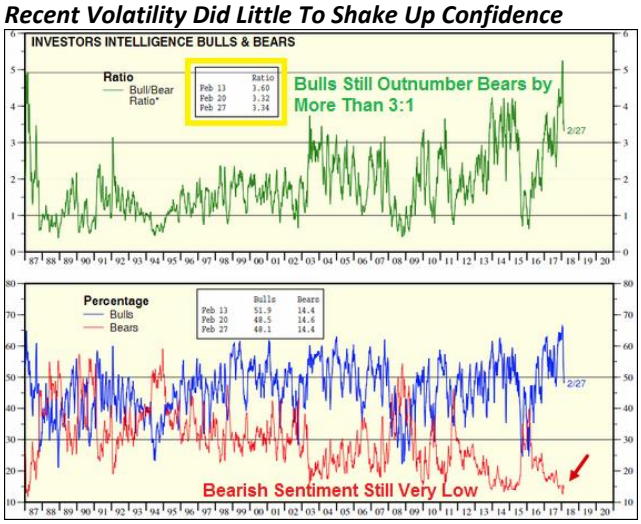
Two Week Slump is Rarely the End of the Turmoil



Source: Bloomberg; BMO Capital

Yet it seems there is widespread hope that we return to that steadily elevated environment of 2017. As Ed Yardeni highlights in the chart below, despite the recent market shake-out, Bulls still outnumber Bears by a factor of 3:1. In fact, the number of those with a bearish outlook continues to decline.

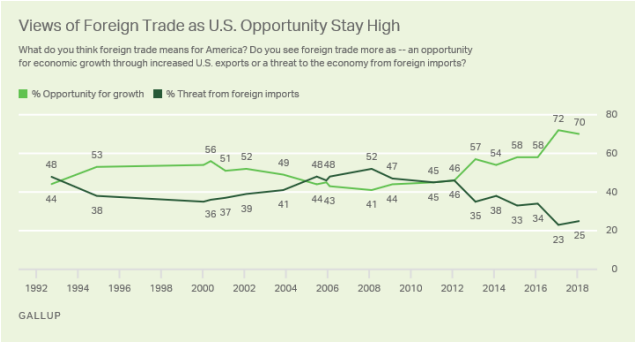
Recent Volatility Did Little To Shake Up Confidence



Source: Ed Yardeni

If we move to the parallel idea that consumer confidence is also near all time highs we are left with a conundrum. Why are consumers, who have not seen much wage growth, who are now as levered as they were during the Global Financial Crisis, and who are now spending the bulk of their disposable income on food and energy bills, so optimistic? Well, one reason is that they overwhelmingly believe global trade is an opportunity for economic growth as seen below.

Americans Overwhelmingly View Trade as Opportunity



Source: Gallup

This brings us to our current situation which unfortunately can be likened to being held hostage by Trump's inexplicable decision to push forward with trade tariffs. Before we further discuss the topic, let us just begin by saying loud and clear that the notion of trade tariffs helping an economy is absurd to put it mildly, and self-defeating to be frank. Every respected voice in economics from Adam Smith to Milton Friedman has pointed out the folly of the practice, but to put it in very simplistic terms, trade is not a zero sum game with winners and losers as Trump believes. On the contrary, it is a POSITIVE sum game where both parties benefit. There is plenty more to say on this topic but lets address exactly what Trump is talking about.

US Trade Deficit Spans Virtually all Goods and Regions

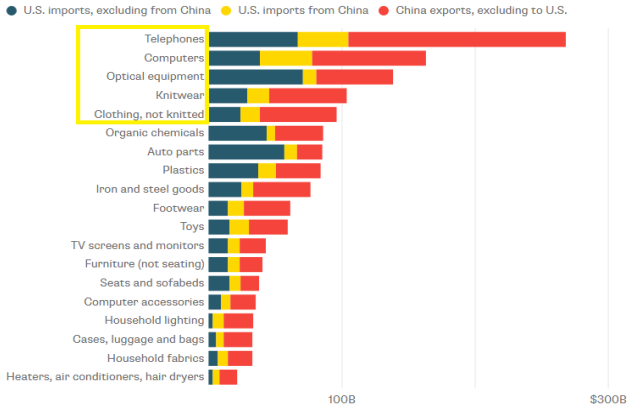
Exhibit 23: Although China is the clear outlier, the US has a net trade deficit in goods across nearly all industries and regions
Balance of Goods by Trading Partner; $ billions. Any balance +/- $15 billion bolded for emphasis

Balance of Goods in 2014, By Trading Partner* ($bn)	China	Euro Area	Japan	Mexico	Pacific**	Canada	Middle East	LatAm	All
Computer	-151.9	3.4	-8.0	-11.0	-26.1	20.9	5.8	12.1	-155.0
Oil, Gas, Minerals	1.9	6.4	2.4	-20.8	1.1	-79.8	-45.1	-15.9	-149.7
Transportation	10.9	-30.9	-46.2	-59.5	-0.5	-6.1	17.1	8.8	-106.3
Apparel	-56.3	-4.9	0.6	-4.2	-6.3	2.5	-0.3	-1.1	-69.9
Electrical Equipment	-35.9	-2.4	-4.0	-8.5	-3.3	10.0	1.8	2.0	-40.4
Misc. Manufacturing	-35.3	4.9	2.7	-2.8	-1.4	5.8	-1.5	1.8	-25.8
Furniture	-18.3	-1.2	0.0	-1.6	-2.1	0.4	0.2	0.0	-22.6
Machinery	-19.9	-27.0	-18.8	3.9	7.6	18.1	4.5	9.1	-22.4
Primary Metals	-3.1	3.1	-1.8	1.0	1.9	-8.9	-0.9	-10.4	-19.1
Fabricated Metals	-17.9	-5.9	-3.5	2.8	-4.3	7.3	1.2	1.9	-18.5
Plastics	-15.7	-1.9	-2.0	5.7	-4.1	2.6	-0.1	0.5	-15.0
Textile	-12.3	-1.1	-0.3	2.8	-4.6	1.5	-0.9	0.2	-14.7
Beverages, Tobacco	1.3	-9.9	0.6	-3.3	0.0	1.0	0.2	-0.6	-10.6
Nonmetallic Minerals	-6.1	-1.9	-0.4	-1.2	0.1	1.9	-0.5	-0.8	-8.9
Paper	-2.7	1.2	1.1	4.3	1.2	-9.8	0.9	-1.9	-5.8
Chemical	-3.9	-29.5	-1.5	19.1	3.2	4.6	-2.4	15.8	-4.7
Food	0.7	-3.6	6.1	4.9	0.9	0.1	1.4	-1.1	9.5
Agriculture	17.8	6.2	7.3	-3.0	5.7	-0.8	2.8	-6.5	29.5
Petroleum	0.6	-1.2	0.1	16.6	-2.0	-0.1	0.6	19.3	32.9
All Goods	-346.1	-106.1	-65.6	-54.9	-33.0	-29.0	-15.1	32.3	

Source: Goldman Sachs Global Investment Research

Above is a snapshot of what the US trade picture looks like. Essentially, the US buys more from the rest of the world than it sells abroad. And that is not either good or bad. It is contingent on mutual utility. We are good at producing food and petroleum and we buy a lot cheap consumer goods. It is clear from the chart above that the US has its largest deficit with China, however, this has absolutely nothing to do with steel.

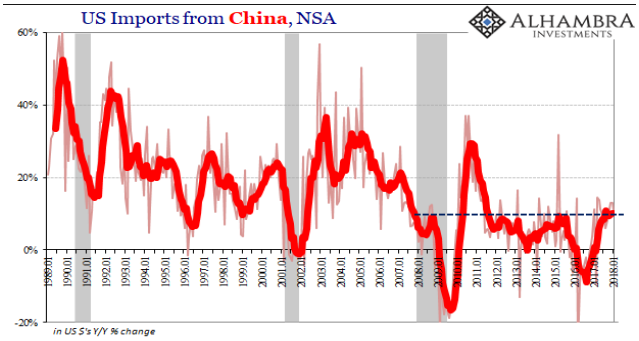
US Imports From China are Largely Consumer Goods



Source: Bloomberg; International Trade Center

The previous chart makes it abundantly clear that the US buys mostly phones, computers and clothing from China. There is a reason for this. They are cheap. If any of those products were produced in the US the cost to the consumer would be significantly higher.

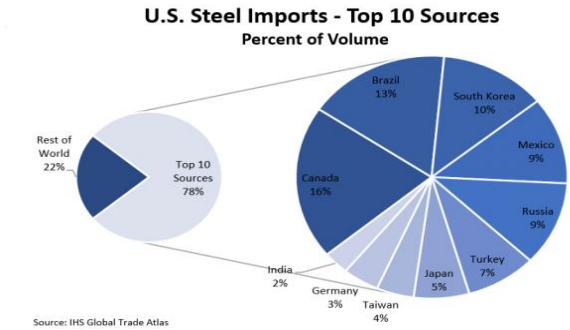
US Imports from China Growing at 10%: Was 30% in 90's



Source: Alhambra Investments; ZeroHedge

While some issues remain, such as intellectual property rights, there is little to suggest that China is taking advantage of the US with a flood of goods. Since 2007, US imports from China have averaged growth of around 10 percent, far below the average 30 percent from the late 1980's through mid 2000's. Fine. Let's just put that aside for a moment and move to the premise that for whatever reason, you simply did not like a trade deficit with China and you wanted to reduce the number. How would you do it? Well, clearly not through tariffs on steel. As you can see below, China is not even in the top ten suppliers of steel to the US, and in fact, US NAFTA partners Canada and Mexico are among the largest. Taxing steel imports would come with a steep retaliatory price tag since 33 percent of total US exports go to those two countries alone according to the US International Trade Commission.

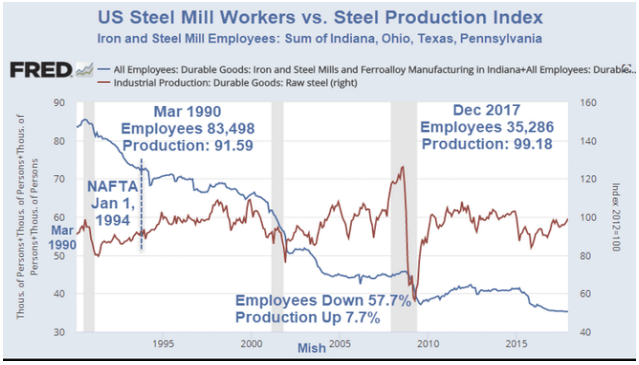
China Not Among Top 10 Suppliers of Steel to US



Source: HIS Global Trade Atlas

What's more, if you were to focus on one area of employment to assist, steel jobs simply wouldn't be the choice for a number of reasons. First and foremost, the jobs that existed in the mills in the 1980's simply aren't coming back because technology (not NAFTA) has eliminated them. According to the American Iron and Steel Institute, in 1980, it took 10.1 man hours to produce one ton of steel – today it takes 1.9. Production is now higher with fewer employees.

NAFTA Did Not Take US Steel Jobs, Technology Did



Source: FRED; Mike Shedlock; ZeroHedge

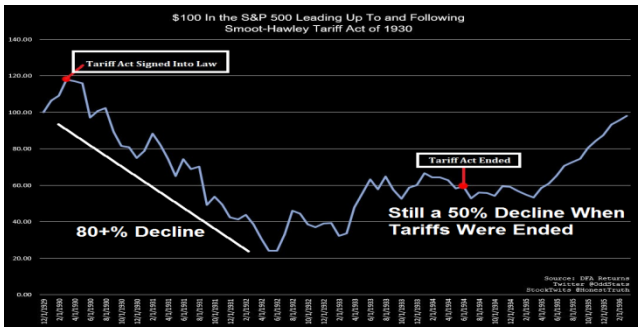
Not only is the technology better now, but others like Canada can produce it much more cheaply since there hydro-powered electricity costs much less. As Blaine Collins at 361 Capital wrote this week, "It makes no economic sense to expand our less efficient U.S. metal capacity. While the tariffs might be a positive for steel and aluminum employees in the U.S., it would be cheaper for all America to just buy every one of the metal employees a new BMW X3 each year rather than send the higher cost of metals through the entire U.S. economy. And of course, the BMW X3 is made in Spartanburg, SC so the U.S. could win a second time." In reality, tariffs are really a tax on the consumer.

Jobs at Risk as a Result of Tariffs Far Outnumber Steel Jobs

Source: BoAML Global Research

The car comment is a joke, but true. As the chart above illustrates, according to the Commerce Department, the number of people employed in steel producing industries is 200,000 while those employed by steel consuming industries number 6.5 million. Tariffs would make the input costs higher for these manufacturers likely resulting in job losses. Estimates vary, but Moody's Analytics this week said they believe the immediate impact would be a loss of approximately 150,000 jobs. This is in no way a pro-growth policy.

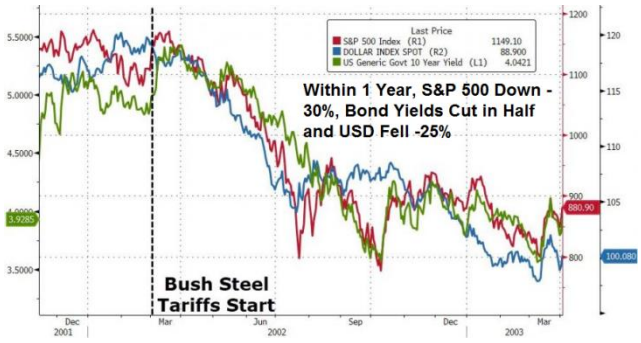
Hawley Smoot Tariffs Threw The US into Depression



Source: @honestruth Stocktwits; DFA Returns

And we have plenty of evidence of the negative follow-on effects of tariffs from the past. In 1930, the Smoot-Hawley Tariff Act was signed, taxing over 20,000 imported goods. This threw the US economy into a downward spiral ending with the Great Depression. More recently, President George W. Bush enacted steel tariffs in 2002 with similarly negative results. The tariffs resulted in job losses of approximately 250,000, decreased overall trade volumes, and a 30 percent collapse for the S&P 500 in just one year.

Bush Steel Tariffs in 2002 Caused Job & Market Losses



Source: ZeroHedge

No one wants to revisit these failed experiments. As news of their renewed possibility spread, industry leaders themselves, from automakers, to homebuilders , to energy executives, have spoken out in opposition. And we haven't even discussed the impact of retaliation by other regions yet. Already, Canada, the European Union and China have publicly stated that they would respond in kind to any US tariffs. The EU has even formalized a plan that would cost the US roughly $3.5 billion in trade. And China, as the other largest economy in the world, has in a reserved manner said via it's Foreign Minster, "History has shown that fighting a trade war has never been a correct way to solve a problem. Especially given today's globalization, choosing a trade war is a mistaken prescription. The outcome will only be harmful. China would have to make a justified and necessary response."

Global Economic Momentum Slowing – Data Disappointing

Source: Zerohedge

This trade rhetoric also comes at a time when global growth is declining at a fairly significant rate. As you can see from the chart above, the Global Economic Surprise Index has been in sharp decline since late 2017, meaning that economic data is disappointing expectations. This is exactly the wrong time then to be placing barriers on global trade. And in fact, the US has declined in relevance somewhat, falling from 35 percent of global GDP in the late 1980's to just 24 percent today according to the IMF. So China and Europe can clearly find other partners to trade with if they so choose. What's more worrisome at this point however, is that the US has put itself in a position of weakness by implementing policies that will result in a $1.2 trillion deficit. To finance that debt, the US needs lots of foreign buyers of its Treasuries. If they so choose, a huge blow could be struck to the US economy by simply not showing up at the large US debt auctions looming on the horizon.

Going Forward

In the first two months of 2018, concerns around stretched equity valuations and overbought conditions have eased somewhat. However, international relations and Trump's unpredictable behavior with both other global leaders and members of his own administration have evolved into a much more significant set of risks. As we stated previously, the stock market price correction in January and early February was certainly not unexpected in our view and was justified. However, with index levels 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.

Assuming a benign environment for the time being, within US equities, we favor the information technology, financial and energy sectors in particular and have been adding to these areas on a selective basis. 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 what was a -20 percent return in the summer of 2017 and the fundamental supply and demand environment has now become a tailwind reinforced by the recent move higher in oil prices. Energy stocks were hit particularly hard during the 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 could possibly become more attractive. Valuations relative to large cap are not especially compelling and borrowing costs, which are substantial for small companies are likely to rise along with interest rates, thus keeping us on the sidelines. However, smaller non-global companies are generally less impacted by tariffs so it is an area we are monitoring.

Particularly in light of a protectionism stance here in the US, 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 and 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 from the bond market has now shifted from a flattening yield curve to a rapid increase in rates. At a minimum, the market consensus is for four rate hikes this year and as we discussed 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 what we view as an unsettled environment as 2018 progresses, 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.