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2nd QUARTER OUTLOOK

The Handoff

As we entered 2018, the economic picture and the stock market were both pretty easy on the eyes. Stocks were coming off a great 2017 and the economy seemed to be on the right path- so much so that the Fed came into the new year with the intention of raising interest rates as many as four times. Indeed, a "handoff" was in process. For the past 8 years, monetary policy as implemented by the Federal Reserve (the U. S. Central Bank), was the tailwind for the bull market in stocks, and often the only thing that market bulls could hang their hat on. Indeed, fiscal policy (congressional legislation) was not only nearly non-existent, but actually a headwind for stocks, albeit one that was overshadowed by accommodating monetary policy.

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But all that was changing as we entered 2018. The Fed had already begun to change course with a series of rate hikes over the past year and a half, after ending the quantitative easing process a few years ago. So, the Fed is no longer a tail wind for stocks. Rate hikes, even from very low levels, are a

headwind for stocks. But fiscal policy has changed too. As we entered 2018, fiscal policy, including the tax bill and deregulation, was now actually a tail wind for stocks. So the Fed, if you will, was handing the ball off to government policy, with the two basically changing roles. Now fiscal policy would be the helper to stocks, while monetary policy would be the headwind.

With all this developing, stocks enjoyed a robust move to the upside in January. Though monetary policy was no longer a help, rates were still low, and besides, fiscal policy will more than make up the difference. Indeed, the tax bill alone should add a nice boost to S&P earnings in 2018 and beyond.

Things seemed to be going just fine until the markets got a look at the February jobs report. The number of jobs created was good, but that trend has been good for quite some time now. What was different in this report was the average hourly wage number. For the first time in a while, though it had been gradually trending higher, the number was bigger than expected. In fact, the wage number seemed to spook the markets. Bonds sold off a bit (rates rising) and stocks began to tumble. Was all this worry about inflation warranted? Perhaps not, but stocks began a downturn that would result in a 10% drop from the late January highs.

Stocks dipped into correction territory, but found support at the 10% level and near the 200 day moving average. In March, stocks had periods of recovery, challenging the old highs as well as periods of decline where the February lows were tested. It appeared that we were developing a trading range when a monkey wrench was thrown into the proceedings – tariffs. As mentioned, fiscal policy had become the wind at the back, a catalyst if you will, for stocks in 2017 and in early 2018, but the President’s tariff proposals could undo some of those benefits. Simply stated, markets don’t like the uncertainty of potential trade wars. The result of the tariff talk was massive volatility and another test of the 200 day moving average and the February lows.

As we begin the second quarter, the volatility continues to heighten as the markets are reacting violently to headlines.

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Corporate Earnings

As mentioned, the tax bill and a series of deregulations should be a big help to corporate earnings. Analysts now believe that the S&P 500 could earn as much as \$155 per share in 2018. That is quite a bit higher than previous estimates and sheds a different light on the valuation discussion. At that level of earnings, the P/E (price to earnings) ratio of the S&P 500 looks a lot more reasonable at 16-17 times earnings. Valuation is not a predictor of where stocks are going, nor is it a catalyst for stocks up or down, but valuation is a measuring stick for investors who care about fundamentals

(seemingly less and less of those these days). It doesn’t hurt the case for stocks, if instead of being perceived as expensive, they are instead perceived as being fairly valued.

I know we say that every earnings season is important, and indeed each one is, but given recent volatility and the never ending plethora of market moving headlines, a solid earnings season might be just what the doctor ordered for the bulls. Evidence of improving corporate earnings resulting from fiscal policy as well as general economic activity, could do wonders for the psyche of the market. Let’s be frank, at the moment, market participants have become a little jittery. The complacency that we have been referring to, and quite frankly worrying about, has now been replaced by some discomfort, if not downright concern.

Having said that, all signs point to a good earnings season, and since share prices have been “adjusted” over the past 10 weeks, it would seem that we have a good set up for the next several weeks – earnings should be good, and share prices are less expensive than recent earnings periods.

The Economy

For years, the cry from politicians and the media has been that the recovery over the past several years has occurred much more on Wall Street than on Main Street. Well, that may be changing. As we have seen, the party on Wall Street has been interrupted recently, while better times on Main Street might be just beginning.

The unemployment rate sitting near 4% is showing continuing strength in job creation. One might say that we are actually beginning to run out of workers. Durable goods orders, leading indicators, personal income, and

manufacturing all have shown strength recently, though not so much as to produce inflation pressures. Though first quarter GDP might be muted, it's likely that we are on a path to higher numbers in coming quarters. Indeed, GDP growth aided by gains in consumer and industrial markets mixed with improved take-home pay for many Americans could provide a road to better times on Main Street as 2018 unfolds. Of course, outside influences such as a global macro political events or political turmoil here at home could disrupt the path that the economy is on, but as always, those events and circumstances are unpredictable as are the outcomes that they may cause.

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Stocks

Last quarter we talked about the “raging bull market” we were experiencing and that increased earnings power from the tax bill might be enough fuel to keep valuation concerns at a minimum. But, we have been pointing out for some time that “the Street” was getting a bit giddy, and that complacency amongst individual investors had set in. We mentioned the craziness that was occurring in the “crypto currency” world and of course had concerns that at any moment political headlines or global macro events could derail the positive environment for stocks.

Well, we'll find out shortly about earnings (as mentioned they should be good), but the crypto currency world has seen a collapse (not a bad thing), global macro concerns continue, and at home, political headlines are endless. The complacency that had

prevailed seems to have been replaced by concern if not outright fear. We saw a rather intense outflow of funds from stocks in February and March, and the “experts” on Wall Street no longer seem giddy. In fact, a bearish cloud has descended upon the landscape.

As we mentioned, the economic backdrop and corporate earnings should be a tailwind for stocks. Unfortunately, political headlines, talks of trade wars and uncertainty in general are providing a head wind for stocks. In addition, the Fed which was the massive gust of wind into the sails of stocks over the past several years is now becoming at least a minor headwind at this point, and likely will be going forward.

Looking forward, as we enter the second quarter, stocks are fairly valued and earnings should be good. The challenge is that sentiment has changed and complacency has been replaced by concern. This tug of war is likely to be evident throughout 2018. Despite good fundamentals, stocks are likely to continue to face the headwinds of a tightening Fed, an unfavorable political environment (including November mid-term elections), and a global macro cocktail of Russia, China, North Korea, Iran and Syria.

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Conclusion

The once apparently smooth handoff from monetary policy to fiscal policy has run into some snags. The Fed had been the tailwind to stocks for years, but that had changed coming into 2018. A tax bill combined with continuous deregulation had seemed to provide more than enough tailwind for stocks, despite the fact that the Fed and its tightening policies (raising interest rates) had now become somewhat of a headwind for stocks. Indeed, stocks roared into the new year with a record setting move to the upside in January.

But, February saw the emergence of inflation fears (which have subsequently been somewhat muted), and then March saw the introduction of tariffs into the mix. Inflation worries and trade war fears took the wind out of the sails of the raging bull market, and now we find ourselves in a tug of war between good fundamentals vs. outside forces. In addition, we have seen a breakdown in the technical trends of both the market leaders as well as the market indices.

The bulls and the bears find themselves in a battle at the moment, one that looks like it might take some time to play out. The bulls have a good economy and good corporate earnings on their side. The bears have confusion, worry, disarray, political and global macro concerns on theirs. Long term, we side with the bulls, but in the short run, one can't ignore the litany of things that can affect the markets.

We get a lot of questions about what to do when things start to get volatile. The answer is simple- don't react. Do not let emotion deter you from your plan. The work we do ahead of time, creating your plan and the allocation of your investments is done exactly for times like this. We had experienced almost no volatility over the past year, but we know that is not normal. Volatility is normal, and to be expected. Indeed, as we say- volatility is the price of admission to get on the ride that takes you down the road to financial success. Emotion is what ruins investment plans, that is why preparing ahead of time and accepting that volatility is part of the process is the recipe for success.

As always, we appreciate that you entrust us to manage your money. We strive to keep you informed and to provide you with the best service in the industry. Please don't hesitate to contact us with any thoughts or questions. If you feel that we can help someone you know and love, who may perhaps be going through a life changing event- divorce, inheritance, selling a business or retiring soon, be sure to let us know.