

## **Market Update for the Quarter Ending March 31, 2018**

*Presented by Joseph Rowley*

### **Stormy March drags down markets**

March was a rough month for financial markets across the globe, as tariffs and trade wars grabbed headlines. All three major U.S. indices were down for the month. The Dow Jones Industrial Average was hardest hit, posting a loss of 3.59 percent. The S&P 500 Index and Nasdaq Composite were down 2.54 percent and 2.79 percent, respectively. For the quarter, a volatile March and weak February more than offset gains in January to leave the Dow down 1.96 percent and the S&P down 0.76 percent. The Nasdaq, on the other hand, managed a quarterly gain of 2.59 percent.

Even as prices dropped during the quarter, the fundamentals continued to improve. According to FactSet, as of March 29, the estimated earnings growth rate for the S&P 500 was 17.3 percent. This would be the highest earnings growth rate we've seen since 2011. Given the benefits of lower corporate tax rates on company earnings, the increase is not surprising, but the magnitude of it is.

Technical factors also weakened during the quarter, with the indices closing close to—but still above—long-term trend lines.

International equities likewise had a tough month and quarter. The MSCI EAFE Index declined by 1.97 percent in March and 1.70 percent for the quarter. Concerns over Russian aggression and potential protectionist policies weighed on investors. Emerging markets had a similarly weak March, losing 1.97 percent. Strong performance in January, however, allowed the MSCI Emerging Markets Index to finish the quarter with a gain of 1.33 percent. As was the case in the U.S., technical factors weakened toward the end of the quarter, taking these indices close to their long-term trend lines.

Unlike stocks, fixed income rebounded somewhat in March, as yields dropped following a large increase in February. The 10-year U.S. Treasury yield started the month at 2.81 percent and finished at 2.74 percent, leaving the Bloomberg Barclays U.S. Aggregate Bond Index with a gain of 0.64 percent. Rates were still up from 2.46 percent for the quarter, though, which resulted in a quarterly loss of 1.46 percent for the index.

High-yield bonds, which are less affected by interest rate movements, also had a weak start to the year. The Bloomberg Barclays U.S. Corporate High Yield Index was down 0.60 percent for the month and 0.86 percent for the quarter, as spreads increased on rising risk perception.

### **Economic growth continues as February concerns abate**

Despite the market turbulence, March was a solid month for economic news, with healthy data alleviating concerns about slowing growth. To start, gross domestic product (GDP) growth for the fourth quarter of 2017, which had been revised down to 2.5 percent, was revised back up to a strong 2.9 percent annualized. The increase was driven by better-than-expected consumption growth.

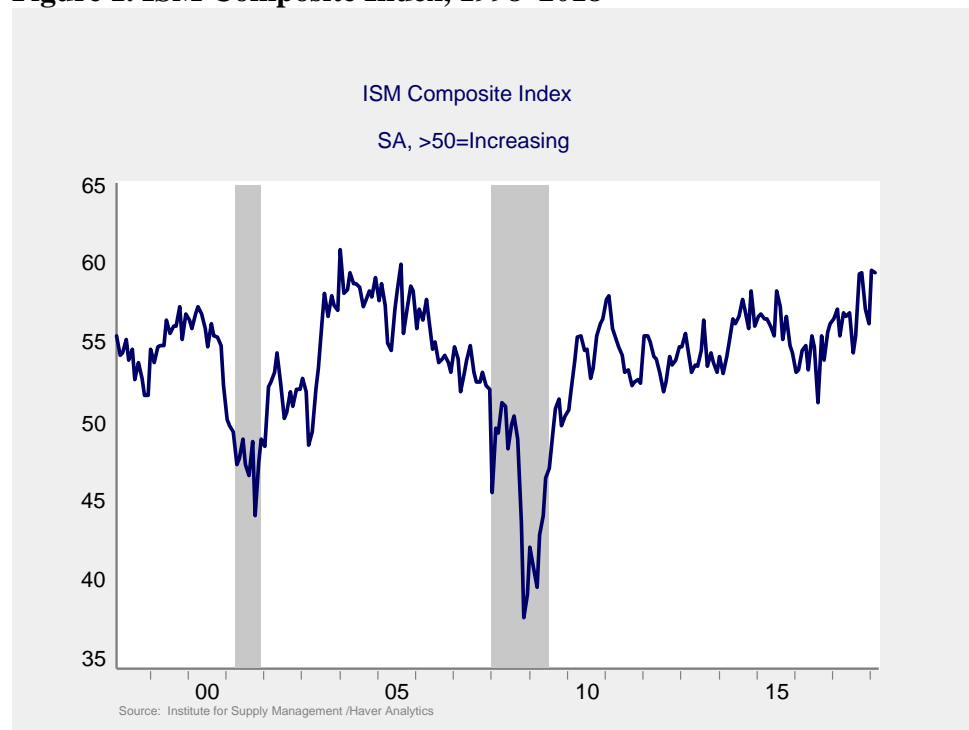
Another example is the February employment report. A staggering 313,000 new jobs were added in the month, with another 39,000 added to the already strong January report. The average workweek also increased by more than expected. This takes job growth for 2018 well above 2017 levels and suggests that the recovery continues to have legs.

The Federal Reserve recognized that economic momentum in March when new chair Jerome Powell announced a 25-basis-point hike in the federal funds rate. Markets expected this decision, seeing it as confirmation of the strength of the current expansion. Market participants expect two to three more rate hikes in 2018.

### **Both business and consumer confidence remain strong**

With gains in employment and continued economic growth, confidence remains near multiyear highs. On the business front, the Institute for Supply Management (ISM) Manufacturing and Nonmanufacturing indices are in healthy expansionary territory. In fact, following a slight dip in December, the ISM Composite index currently sits near highs last seen in the mid-2000s (see Figure 1). This level of business confidence has historically been associated with GDP growth of 5 percent. Although it is unlikely we will see that sort of growth, the rebound in business confidence is a very positive sign.

**Figure 1. ISM Composite Index, 1998–2018**



Businesses were not the only ones who were confident in March. Consumer confidence moved back up as well. Consumer confidence is driven largely by employment and wage growth. And with strong jobs numbers to start the year, not to mention improvements in wage growth, it is no surprise that consumer confidence is near highs last seen in the 1990s.

Of course, what really matters is whether businesses and consumers are actually growing their spending. Fortunately, the spending data improved along with confidence.

Durable goods orders, which reflect business investment, bounced back from a weak January with growth of 3.1 percent in February. While the headline figure was impressive, it was the recovery in core durable goods orders that was particularly encouraging. The measure of core business investment grew by 1.2 percent for the month, which was more than enough to offset earlier declines. The combination of high business confidence, low borrowing costs, and lower corporate tax rates suggests that businesses are likely to keep spending as the year progresses.

Although business spending improved, the news on the consumer side was mixed. Retail sales disappointed in February. The more current personal spending data beat expectations, however, with growth steady at 0.2 percent. Overall, consumer spending is not growing like business investment, but it *is* growing and is likely to increase further.

Another area of potential concern for consumers is the housing market. Homebuilder sentiment declined in March, as rising costs and labor shortages weighed on profits. Besides that, housing starts and building permits both declined by more than expected. One month's data isn't enough to form a trend, but we will want to watch this area of the market. Supply shortages for new homes could lead to a material slowdown.

### **Political risks surge to the forefront**

As the economic fundamentals remain solid, political risks remain a concern. The White House's announcement of two separate tariff programs—on steel and aluminum imports and on Chinese goods—raised the perception of risk dramatically. The actual impact of the tariffs is theoretical at this point (they appear to be more negotiating tactic than settled policy). Even so, the very real risks of a trade war and the consequent economic damage spooked markets during the month.

International risks also continued to garner attention. Following the attempted assassination of a former Russian double agent in the U.K., many western countries responded with a coordinated expulsion of dozens of Russian diplomats. Russia has promised to retaliate in kind, increasing the odds for further political disruptions. As is the case with the domestic political risks, the direct economic impact of this is likely not high, but the potential for future volatility is worth monitoring.

### **More volatility ahead?**

The first quarter had its ups and downs. And there are certainly economic risks to keep an eye on—weakening housing data in particular. Still, improving fundamentals and high confidence levels should keep driving the expansion.

Markets may be more at risk, though. The political risks strike directly at confidence and have the potential to drive more volatility like what we have seen in the past two months. That said, the strong fundamentals should help cushion the damage. As consumers and companies continue to feel the positive effects of tax reform, fundamentals are likely to keep improving as well, which should also buoy financial markets. As always, short-term volatility, while worrying,

should be balanced against your long-term goals. A well-diversified portfolio that matches your risk tolerance and time horizon remains the best way to meet those goals.

*All information according to Bloomberg, unless stated otherwise.*

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