ALTMAN
INVESTMENT MANAGEMENT

BRIEF REFLECTIONS

OCTOBER 16TH, 2018

Thoughts on the Market Volatility:

The 5.3% drop in the S&P 500 last week suggests that investors may be factoring in the prospect that the U.S. economy will be slowing at a faster rate than the Fed anticipates. The FOMC minutes last week eliminated the language of "data dependency" and "accommodation" which had the effect of spooking markets that now anticipate monetary policy could be too restrictive and cut off economic growth. Although we have been in the camp that believes the Fed is normalizing rates, the recent policy tightening in September in response to accelerating growth may have resulted in a larger than usual increase in market interest rates. The spread between the 2-year and the 10-year Treasury grew wider and at a faster pace than previous tightening cycles. If the spread continues to widen sooner than the market expects in 2019, it could cause further equity price erosion in the U.S. and elsewhere. This may force the Fed to pause hiking rates and result in the Federal Reserve policy holding Treasury yields steady.

The reaction of equity prices appears to indicate that investors are beginning to discount the possibility that higher interest rates will cause the economy to slow in the not-too-distant future. Until recently, increases in Treasury yields have generally coincided with a rising S&P 500 and cyclical stocks outperforming, as both bond yields and equities were pushed up by good news on the economy. But this week's drop in the Standard and Poor's 500 Index, and marked underperformance of cyclical sectors before the correction, has come in the wake of a 40bp surge in the 10-year Treasury yield since mid-August. There has been no other obvious near-term trigger in the economic data.

We don't think that we are at the later stage of the economic cycle where higher rates begin to strangle growth, as supported by the recent strong U.S. economic data. It is certainly possible that the recent drop in the stock market reverses over the next few days or weeks. That is, after all, what happened back in February of this year when the S&P 500 plunged by 10% on the back of another sharp rise in Treasury yields. Nonetheless, we think that a deceleration in economic growth could shift to only a few quarters away, and ultimately push Treasury yields higher and limit the upside to S&P 500 valuations by the end of next year. While we are not anticipating anything as dramatic as a global financial crisis, we do think the possibility has increased that economic growth could be under some pressure by mid-2019. There seems to be little evidence so far that the Fed will move to the sidelines on its tightening cycle. However, if equity prices continue to tumble over the coming weeks, the Fed will likely temper their approach. But as long as markets stabilize, solid activity growth coupled with higher wage inflation should be enough to keep the Fed on track to raise interest rates again in December.

We remain constructive on markets, and are viewing the recent retreat in stock prices as a bull market correction coincident with a leadership change in equity sectors. We believe the U.S. economic expansion will continue at 3.0% GDP pace into next year and revised our earnings projection of +10% growth over last year. As long-term investors, we believe that in spite of significant volatility and global noise, we are still not overly concerned that the decline in equity prices is signaling any fundamental shift in capital markets that would change our current asset allocation bias.

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