ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

APRIL, 2018

"I have noticed that even people who claim everything is predetermined and that we can do nothing to change it, look before they cross the road."

Stephen William Hawking, physicist, January 8, 1942 - March 14, 2018

IN FOCUS:

As investors, we need to continually remind ourselves of the great lessons of Professor Hawking; use our intelligence to adapt to change, be a conduit of change, and learn from our history. His insight, tireless spirit and unwavering optimism inspire us as we face an ever-changing global economic landscape.

After a year marked by high returns and historically low-price volatility in U.S. and global equity markets, the first quarter of 2018 can be described as bouncing from elation to fear and back again. The volatility in 2017 reached record lows - only 9 trading days in which prices moved by greater than +/- 1.0%.

The broad market indices achieved all-time highs in late January with global markets producing YTD total returns of +7.3% (MSCI ACWI Index). Only to shift quickly in February as concerns that a strong report on U.S. wage growth was a leading indicator of rising inflation - contributing to a stock market decline early in the month. The surge in so-called "implied volatility" (as measured by the VIX Index) wiped out earlier gains for the year. Theses market gyrations can be the result of unexpected economic reports or "tweets" from the White House, followed by resumption of good earnings releases or a more conciliatory policy response to negative market reactions.

Although the past three months of market volatility have not been easy to live through, the passage of time combined with continued strong earnings growth has left the S&P 500 with a much-improved valuation. The S&P 500's forward price-to-earnings (P/E) ratio, which stood at 18.6 in late January, has declined to 16.2. That's a pretty speedy drop, and it places the index's forward P/E on its 20-year average.

CLOSE-UP: The Economic Landscape

There has certainly been a shift in some of the fundamental factors that influence equity prices. This shift started off with a disappointing payroll report in March which indicated that the U.S. economy may be losing momentum. The institute for supply management reports for both manufacturing and services is still positive but showing signs of rolling over. European industrial output declined for the third consecutive month. Personal consumption expenditures seem to have bottomed and prices appear to be heading higher. Consumer sentiment dipped in April, after reaching its highest reading since January 2004. Overall concerns that the Federal Reserve (Fed) interest rate normalization policy may be too restrictive reflect the given evidence of slowing economic activity.

The aforementioned market noise aside, news about the U.S. economy continues to be a net positive. The overall economy (as measured by GDP) grew at a +2.3% annual rate during the first quarter, but still lags behind growth posted during most of last year with the trailing 3 quarters at an annual rate 3.0%. The economy continued to produce new jobs, keeping the unemployment rate at a record low. Consumer spending, +3.6% year-over-year in the first quarter, remains robust.

Housing prices continued their long and recently strong climb back from their depressed levels. However, this was followed by concerns that a strong report on U.S. wage growth was a leading indicator of rising inflation and contributed to a stock market decline early in the month. So far this has had only a moderate impact on interest rates, with the 10-year Treasury yield reaching a peak of close to 3.0%.

Real GDP growth is expected to continue to advance at a 2.5% for the foreseeable future, despite the near record length of the current expansion that passed the 105th month mark in March. Forecasts are calling for additional employment gains with the unemployment rate falling below 4%. The Federal Open Market Committee doesn't, at this point, feel that the economy is overheating and is following their game plan of periodic quarter point increases in the Federal Funds rate. The latest increase in mid-March brought the targeted range to 1.50% to 1.75%. Two additional increases this year remain in the game plan, to be followed by further tightening in 2019. Thus far, inflation pressures have remained docile with a year-over-year 2.2% increase in the CPI through March. The Federal Reserve's preferred inflation measure remains below 2.0%.

Chinese Trade Update

Last month, the U.S. imposed a 25% tariff on worldwide imports of steel and a 10% tariff on imported aluminum. Some nations have negotiated temporary exemptions from the aluminum and steel tariffs, but not China. In response, China announced new tariffs of up to 25% on $3 billion worth of U.S. agricultural goods. We believe that neither of those measures initially implemented are expected to make a real dent in either economy, assuming that the tariff spat will be solved amicably. On closer examination, the $3 billion in Chinese tariffs on agricultural goods compare to U.S. exports to China of $140.5 billion of agricultural goods last year, according to the U.S. Department of Agriculture. Ten percent of these exports are soybeans to China. For a sense of scope on aluminum and steel, only about 2% of U.S. steel exports are sourced from China. More broadly, in 2017 the U.S. ran a $375 billion trade deficit with China, which the President aims to reduce by $100 billion.

For perspective on the GDP impacts of the total potential tariffs imposed, Morgan Stanley's global strategist believes that "25% of $150 billion is about $37billion. That seems like a large number, but when you put it in perspective, it's about 0.3% of Chinese GDP. That same $37 billion is about 0.2% of US GDP," as reported in Business Insider. According to Oxford Economics and reported by Bloomberg, the impact on China's economy "suggests a 25% U.S. tariff on $60 billion worth of Chinese exports and a comparable retaliation, would reduce China's growth by about 0.1 percentage point this year and a little less next year."

LOOKING AHEAD:

Looking ahead, we believe that 2018 could still see accelerating economic growth, bolstered by an infrastructure spending program and continued strong economic growth from abroad. Also, with low unemployment, wages should increase above their current 2.5% y/y rate. Any fears of accelerating wage pressures could push inflation rates higher and put pressure on the fixed income markets. This is coincident with the possibility that the Federal Reserve might accelerate their tightening program beyond three moves this year.

As we have outlined in recent commentaries, there is ample evidence to suggest a shift to tighter monetary policy is upon us, after years of quantitative easing that drove down credit premiums, negated term premiums and suppressed volatility. While the U.S. Federal Reserve is leading the way, other developed world central banks are joining in, perhaps sooner than many investors expected. In a recent policy statement, the European Central Bank (ECB) dropped its assurance to increase asset purchases in the event the economy deteriorates. The Bank of England (BOE) lifted its growth forecasts, cautioning that rate hikes could come "earlier" and to a "greater extent" than originally expected. And the Bank of Japan (BOJ) is subtly reducing the amount of its bond purchases.

In tandem with the removal of accommodative policy, the U.S. has unleashed fiscal stimulus via tax cuts and budget increases that will require an ill-timed increase in Treasury supply. Rates seem inevitably set to move higher. Still, we believe inflation will be the ultimate determinant of where things shake out. We are watching closely to see if the incipient signs of inflation have staying power, which could force the Fed into a faster pace of rate hikes than are currently forecasted, or if both growth and inflation will taper off to expected levels, allowing the Fed to proceed at its measured pace.

A Fed policy of normalizing rates provides the room to lower rates later so as to avert an imminent recession. The longer the Fed can keep the expansion going, the more bullish that should be for stocks - even though the short-term increase in interest rates creates somewhat more competition from bonds in this scenario. One could draw the conclusion that the Fed's ongoing tightening confirms that the economy is strong enough to absorb the gradual normalization of monetary policy. If the yield curve were to steepen, with bond yields rising faster than short-term rates, then we would have to worry that the Fed is "behind the curve" in keeping a lid on inflation.

The Yield Curve Has Been Flattening Not Steepening

The most recent behavior of the yield curve suggests that the Fed is doing the right thing, i.e., keeping inflationary pressures in check. Risks would include geopolitical events involving Russia and North Korea, high sovereign debt levels, trade policies of protectionism, and the success or failure of central bank policies as they tighten monetary policy. However, these risks appear to be reflected in overall stock market prices with a forward P/E of 16.2; and long-term consensus earnings growth expectations of 15%+ suggest that the equity market valuations are still not excessive.

Our forecast for 2018 primarily incorporates faster economic growth, higher inflation, and significantly higher corporate profits. We are expecting 3.5%+ GDP growth, 2.7% CPI inflation, and corporate profits accelerating over last year's results. In terms of the S&P 500 index, earnings could approach $157 per share. The main risk continues to be a considerably higher inflation rate that could lead to a recession.