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Market Perspectives February 2018

JIM BAIRD
CPA, CFP®, CIMA®
Partner,
Chief Investment Officer

TRICIA NEWCOMB
CIMA®
Associate,
Senior Strategy Analyst

Executive Summary

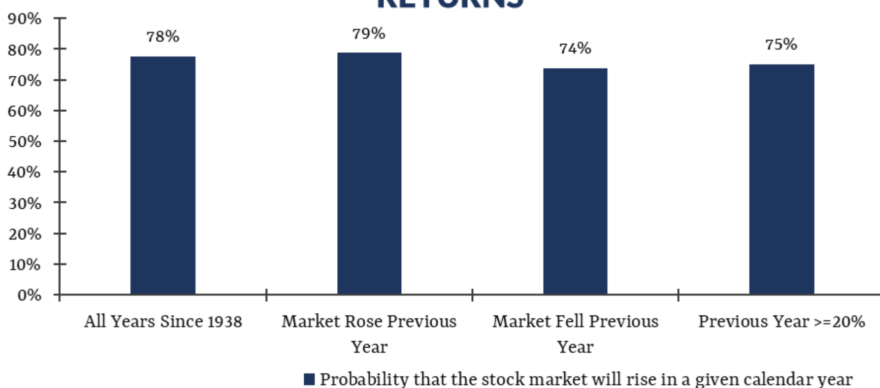
- U.S. stocks extended their rally in January. The S&P 500 led the way with a 5.7% gain, followed by mid caps at 3.8%, while small caps rounded out the pack with a 2.6% increase.
- Fixed income performance was mixed in January, with high-quality bonds slipping as long-term yields edged higher, while more risk-correlated bonds (such as high yield) advanced.
- Volatility reared its ugly head in early February, pushing stocks sharply lower and marking the end of an unusually long period of calm in the equity markets. Despite that, economic fundamentals still look strong and our overall outlook remains largely unchanged.
- If anything, the correction took some froth out of equities, bringing valuations back down toward more reasonable levels.
- Initial estimates indicate that the U.S. economy expanded at a 2.6% pace in the final quarter of 2017, falling slightly short of expectations, but still representing a healthy pace of growth.

Monthly Insights

"The stock market had such a strong year in 2017, will that affect its performance this year?" Many are asking this very reasonable question. History clearly suggests that the answer is a resounding "no."

Over the past eighty years, U.S. stocks have risen in about four out of every five years. The probability of the market being up in a given year didn't change materially if the market was down or up in the prior year. Even coming off calendar year returns 20+% returns (such as 2017), the probability of a positive return the following year was statistically the same.

While the volatility in recent weeks might give investors reason for pause, the bottom line is that the strong performance of stocks last year is likely to have little bearing on the returns for equities in 2018.



Source: PMFA, Morningstar

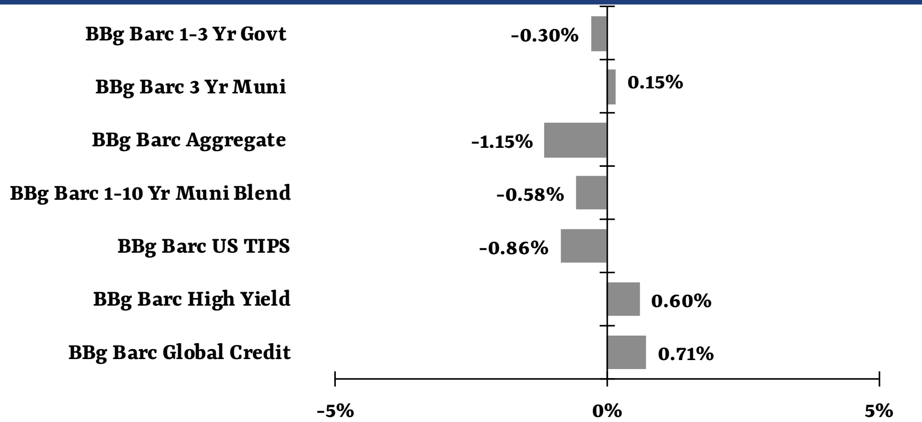
Returning to normal

Note: The content for this month's Market Perspectives was largely completed before the recent stretch of market volatility that emerged in early February. As long-term readers know, Market Perspectives is intended to provide an overview of events and developments in the capital markets in the preceding month. In acknowledgment of that recent volatility, we have supplemented our comments throughout to provide additional context, but the focus of the piece remains on market performance and drivers in January.

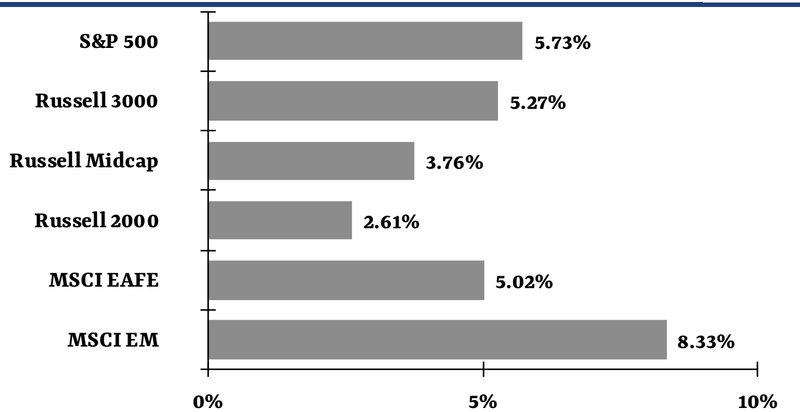
For additional thoughts on recent volatility, please see our recent commentary "Until it Returns."

PERFORMANCE OVERVIEW - AS OF 1/31/18

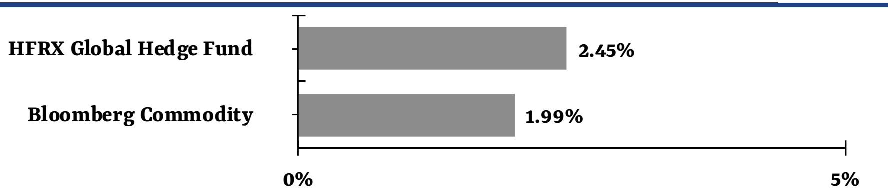
Fixed Income



Equity



Alternatives



Source: PMFA

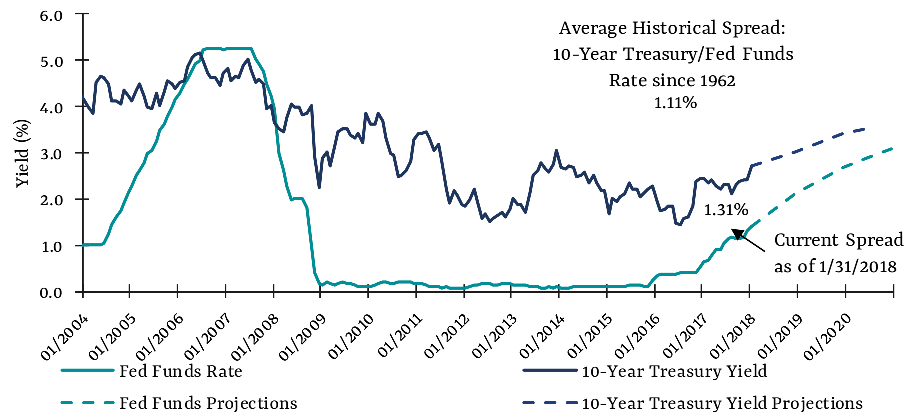
Stocks came out of the blocks quickly in January, driven by rising investor optimism and supported by strong fundamentals. At the same time, rising long-term interest rates weighed on bond prices. Still, the sudden return of higher volatility in the first few days of February – the first such spike we've seen in nearly two years – served as a reminder that equity values can move rapidly, upwards or downwards, as investor sentiment changes.

Why are investors recalibrating their expectations? The primary catalyst for this didn't stem from concerns about unexpected economic weakness, but signs of economic strength. Recent evidence of further tightening in the labor market, growth in real wages, and an uptick in the consumer price index all provided indications that inflation pressures are building. Long-term interest rates had already been moving higher since September, but the strength of the recent data not only pushed long-term rates higher still, but prompted investors to rethink their expectations for Fed policy as well. Prior skepticism about the Fed's rate forecast has faltered. And with investors increasingly resigning themselves to higher rates ahead, they also recalibrated their expectations for equities. The resulting 10+% decline in stock prices pushed the Dow and S&P into correction territory in recent days, relieving some of the froth in the market. Just as sentiment had carried stocks higher, its quick reversal eliminated January's gains – despite the fact that underlying fundamentals for the economy and corporate profitability remain largely positive.

As we prepare this, it's still too early to determine whether the recent swing in sentiment and concurrent equity market decline will fade as quickly as it

appeared or if it represents the front end of a more prolonged period of heightened volatility. While market events like those of recent days can be a source of anxiety for investors, both volatility and periodic corrections are normal elements of a typical market cycle. In fact, as we've noted a number of times over the past year, the extended period of relative tranquility the markets experienced in 2017 was anything but typical. A return to a more normal market environment, with the periodic volatility that comes with it, was to be expected.

TERM SPREAD STILL ABOVE LONG-TERM AVERAGE



Source: PMFA, FRED

Taking a closer look at economic fundamentals, initial estimates from the Commerce Department indicate that the U.S. economy grew at a 2.6% pace in the final quarter of 2017, falling slightly short of expectations. For the year, GDP expanded by 2.3%.

Digging deeper into the numbers, there were a number of positives within the report, including strong growth in personal consumption, residential investment, and business investment. Overall, though estimated top-line growth moderated after two consecutive quarters of growth in excess of 3%, they still portray an economy that is healthy and growing.

The most recent labor market report also reflected continued strength in job creation and the strongest pace of growth in hourly wages since 2009. Both should support continued strength in consumer confidence and spending, but they are also likely to translate into increasing wage costs for employers and rising competition for talent, which in turn create additional inflationary pressure.

Looking toward 2018, economists expect that personal and business spending could be spurred higher by the recent tax cuts, though the extent of potential near-term stimulus remains to be seen. Broadly, economists are looking for the tax cuts to boost 2018 growth by 0.25% - 0.5%. For a more detailed assessment of the latest economic developments, you can turn to our [Market Perspectives blog](#).

As expected, the Fed left its benchmark interest rate unchanged following its January meeting, while sticking with its previously outlined course of gradually unwinding its balance sheet. The change in leadership at the Fed might create some additional uncertainty. For now, a continuation of the existing policy appears most likely, though recent data has raised the specter of higher inflation driving policymakers to tighten more rapidly.

As noted above, it was that concern that directly contributed to the recent spike in market volatility. It appears unlikely, however, that the Fed will deviate significantly from its long-term interest rate target, and regardless of any near-term adjustments in its plan, the fact is that monetary policy remains relatively accommodative today.

Turning to January market performance, domestic equities extended their rally, with all of the major benchmarks delivering strong returns. The large cap S&P 500 led the way with a 5.7% gain, followed by mid caps at 3.8% and the small cap Russell 2000 with a 2.6% increase.

Given the recent market jitters concerning the potential impact of higher interest rates on stock performance, has the overall outlook for equities changed? The short answer is no. The factors that have contributed to the stock market's strong performance over the past year – healthy economic expansion, renewed earnings growth and a synchronized period of increasing global economic activity – appear poised to continue in the near term. At the same time, monetary policy and fiscal policy are both supportive of further growth. If anything, the recent correction helped to take some of the froth out of valuations, and U.S. equities (particularly large caps) look more reasonably valued today.

Overseas equities also enjoyed a strong month, performing as well – or better – than their domestic counterparts on a U.S. dollar basis. The emerging market MSCI EM index returned an impressive 8.3% in January, while the developed market stocks of the MSCI EAFE returned a solid 5.0% over the same period.

We have long maintained that international equities present more attractive valuations and offer higher growth potential than U.S. stocks. As such, we continue to recommend a moderate overweight to international in equity portfolios.

Fixed income performance was mixed in January, with high-quality bonds declining as the yield curve steepened, although more risk-correlated bonds managed positive returns. Municipals fared better than their taxable counterparts as the Bloomberg Barclays 1-10 Year Municipal Blend gave up 0.6% while the Bloomberg Barclays Aggregate index retreated 1.2%. Meanwhile, high yield bonds and global credit benchmarks were in positive territory for the month, adding 0.6% and 0.7% respectively.

Current inflation jitters aside, rising rates on their own should not be a source of anxiety for long-term investors. Clearly, a sharp increase in rates in a short period of time can weigh on near-term bond portfolio performance. However, for long-term investors, higher yields will provide greater income and lead to better returns over time.

So how much could rates rise? From a policy perspective, the Fed has telegraphed that it wants to get to a target of 3% for its benchmark short-term rate over the next few years. Over time, the average term spread between the Fed funds rate and the 10-year Treasury has been about 1.1%. Layering this average spread onto a target policy rate of 3% suggests some upside likely still exists in long-term yields as well. Even with a moderate pickup in growth and inflation, most market strategists still don't expect the 10-year Treasury to reach 4% in the current cycle. The greater likelihood is that as the Fed tightens, long-term growth and inflation expectations are likely to dim, short-term rates are likely to rise more rapidly than long-term rates, and the yield curve will flatten.

How this all plays out remains a topic of speculation and debate. In a global fixed income market characterized by low inflation and low yields, Treasury yields may already look attractive relative to other developed sovereign bonds for many foreign investors. That alone could support demand for Treasuries and help to restrain higher yields. The bottom line is that there are practical limits in terms of how much rates can rise, even against the backdrop of a healthy economy and gradually increasing inflation. Even as rates edge higher, bonds will continue to play an important role in a diversified portfolio, as a risk reducer and source of income for most investors.

Overall, the performance of the equity markets in January continued trends that had been in place for nearly two years. The spike in equity volatility during the first few days of February may have taken year-to-date returns into moderately negative territory, but likely signals a return to a more typical market environment (in which bouts of volatility are normal), and serves as an important reminder that short-term swings can come at any time.

We've acknowledged for some time that U.S. equities weren't cheap. Even after this pullback, stocks aren't bargain-basement values, but the combination of strong earnings growth and the pullback in prices has returned valuations (particularly among larger cap names) to more reasonable levels. That's not to suggest that volatility couldn't pull prices (and values) down further; that remains a possibility.

As we've often discussed, sources of uncertainty always exist, and it is that uncertainty that creates the opportunity for long-term investors to be rewarded for taking risk. Of course, that means staying invested through even volatile periods.

The recent surge in volatility hasn't changed that. The fundamental economic outlook remains quite positive. The strength of that outlook is likely to continue to push rates higher, but reduced equity valuations should help to offset some of the potential headwind of rising rates on future equity returns.

The bottom line: we believe that over a multi-year timeframe, bonds remain a compelling diversifier and source of income, stocks are still positioned to outperform cash and high quality bonds, and patient investors will be rewarded for investing in equities, consistent with their overall tolerance for risk.

Gratuitously Unnecessary Fact of the Month

Grumpy AND Litigious

Grumpy Cat has been a star of social media and internet memes since her debut in 2012, and her apparent perpetual frown has captured the hearts and imaginations of legions of fans.

She's also been a financial boon for her owner, Tabatha Bundesen, who formed the company Grumpy Cat Limited to capitalize on the feline's popularity. The company has produced a bestselling book, a line of clothing and a number of marketing partnerships, including one with the beverage maker Grenade.

However, when Bundesen discovered that Grenade was using her cat's name and image in ways that exceeded their agreement, Grumpy Cat Limited also proved itself to be a fierce protector of its intellectual property. It successfully sued Grenade, winning an award of over $700,000 from a California jury.

We suspect that even with that newfound gain, Grumpy Cat is still grumpy.

Source: Washington Post

Blog

For other up-to-date economic briefs, visit PMFA's Market Perspectives Blog at **plantemoran.com/market-perspectives-blog**.

Past performance does not guarantee future results. All investments include risk and have the potential for loss as well as gain.

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