WESTLAKE
PRIVATE WEALTH MANAGEMENT

Quarterly Market Missive
April 2018

We all knew sooner or later we'd have a brush with volatility….some would say a brush with *reality*. We knew as investors that the market had experienced an average of one 10% correction every year since 1900 and we remembered the 17 downturns stocks had experienced since this bull market began in 2009. Yet we also knew that the markets had been uncharacteristically calm prior to this year, with the S&P 500 enjoying positive returns in 19 of 20 quarters going all the way back to the beginning of 2013 and notching gains for 15 straight months.[1] We all read the pundits' warnings that the lack of volatility was a concern and likely wouldn't last. We wrote about it here in October and again in January. Yet as prepared as we all believed we were, this brush with reality still caught us off guard and prompted many of us to reassess our tolerances.

Let's look at it fundamentally first. The market's recent swings have largely been attributed to two key issues: the fear of rising interest rates and the fear of protectionist trade policies. It's important to point out that rising interest rates are a normal byproduct of a healthy and improving economy and are a good thing at the end of the day. The economy improves in part because more workers are employed, wages rise, dollars flow into consumers' pockets and ultimately back into the economy. Inflation, at some point, becomes an inevitability which the Federal Reserve controls through monetary policy. Longer-term rates, influenced by investors, also rise. Investors fear that these rising rates will increase borrowing costs and impact capital investment, thus pinching growth. Investors also fear that the Fed may err by "over-tightening" and stalling the economy into recession. We believe this is wrong. The Fed has substantial wiggle room for lifting rates. The current Fed Funds rate is 1.75%.[2] Nominal GDP (real GDP plus inflation) is hovering around 3.5%.[3] Monetary policy is typically not "tight" until Fed Funds exceed nominal GDP. Even assuming two additional rate hikes this year, we have a long way to go before that can happen and before the Fed's policy can be considered anywhere near restrictive. If anything, the Fed is only becoming "less loose". Regarding longer-term rates, history suggests that a rising ten-year Treasury is actually a positive for stocks: according to *A Wealth of Common Sense*, we've had 17 periods of rising rates since 1962. During these periods the 10-year Treasury yield rose an average of +235 basis points while the S&P 500's return averaged +21.6%. What's to fear about that?

But what about risks from the Trump administration's protectionist stance? What about the risks of an all-out trade war? Whether we're referring to China, the EU, or NAFTA, the reality is that we don't yet know. Markets loathe uncertainty, so this issue may fester for a while. If there's one thing we've taken away from President Trump, it is that he tends to use smash mouth tactics to negotiate, and that simply does not sit well with investors. Agree with it or not, we need to remember there are cooler heads in Washington whose guidance is rooted in a more rational understanding of global economics and the impact of bad trade policy on the US economy. We acknowledge these issues are maddeningly complex and will take months to resolve, but we trust that the inputs from the cooler heads will prevail.

Looking at the big picture, we see very little risk of recession in the near term. Leading indicators remain positive, quarterly earnings are robust and economic growth remains solid. This is simply not the kind of environment from which recessions or bear markets are born. We do see fundamental risks however. Deep in the economic cycle like this, there is the very real possibility we may see the rate of economic and/or corporate profits growth begin to slow. Even though we're experiencing some of the best quarterly profits in five years (FactSet Research), several high-profile firms have suggested that the bar may be set perhaps a bit too high and this may be the high water mark for earnings. Remember, the market is a discounting mechanism and investors care less about what is happening today and more about what will be happening down the road. With many analysts already viewing stocks as fairly valued, disappointments may not be taken lightly. This is something that bears watching, and so we will.

But we need to get back to the discussion of volatility. More than anything, we need to stress that *volatility* and *risk* are not the same thing. Volatility is simply the price we pay for the opportunity to earn a premium rate of return over time. It is a constant, not an exception. Risk, on the other hand – well defined by Nick Murray - is the "permanent, irretrievable loss of capital and impairment in one's standard of living". If we as advisors have done our jobs well….if we have thoroughly assessed our clients' needs and have thoughtfully matched those needs with appropriate solutions, then we know the ups and downs in the market will not threaten our clients' standards of living. But….what if the volatility continues? What if it gets worse? What if it elicits real fear or worse, emotional knee-jerk responses? Then we do the most important things an advisor can ever do: we listen, and we keep our clients from acting on those fears and emotions. We know the fears of irretrievable loss shouldered by investors in times of heightened volatility can only come to fruition by their temptation to act, so we remind our clients constantly that we are here.

In conclusion – we're deep in the economic cycle and although we see no recession on the horizon, we're mindful that equities are fairly valued and that investors are likely to be ultra-sensitive to any talk of slowing. We continue to expect economic and earnings upside, but we remind our clients that volatility will likely stick around for a while. We also anticipate continued political noise – and it is nothing if not noise. To that end, we encourage our clients to remain focused on the successful achievement of their objectives, to tune-out the irrelevant, and to keep an eye on what really matters.

As always, we so very greatly appreciate the continued trust and confidence you place in us.

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[1] LSA Analytics
[2] Federal Reserve
[3] First Trust