1Q2018 Market Commentary

March 2018

After the S&P 500 recorded positive returns for nine consecutive years at the end of 2017, volatility in many stock market indices shook up the market's complacency in the first quarter of 2018. January's celebration of the benefits of the Tax Reform and Jobs Act proved to be short-lived, as both February and March produced negative returns for U.S. stock markets. This was the first full quarter market decline since the summer of 2015.

The reasons for the weakness were different in each month—February witnessed the comeuppance of strategies shorting VIX (the predominant short-term stock market volatility index) futures and March ushered in fears of the negative impact of trade disputes led by the current administration. The damage from the spike in volatility in February was itself well contained and short-lived, but it reflected the high level of complacency in future market dynamics with investment strategies relying upon the supposed "permanent" low level of stock market volatility. In our view, the abnormally low level of the VIX was never permanent, and the stock market has settled into a higher range of future volatility that seems much more appropriate. As funds that shorted VIX futures had to cover positions (and therefore sell stocks), it did not take long for such investors to get wiped out and the downside pressure on stocks to come to an end.

In last quarter's commentary, we identified negative trade actions as a key risk to the stock market and the economy. We've seen these dangerous actions gather momentum in March, as the U.S. announced its decision to impose tariffs of 25% and 10%, respectively, on steel and aluminum imports. The rhetoric of the President and his trade advisers has continued to add to concern, not lessen it. However, a few modifications to the trade agreement with South Korea, possible progress in renegotiating NAFTA with Canada and Mexico, and ongoing "discussions" with China could result in improved outcomes. But the risk of igniting a trade war is being weighed by the market, and investors don't like such uncertainty. If the Trump Administration had just left well enough alone, with the cuts in taxes and regulations, the market may have sustained a recovery from February's decline. Instead, trade war fears turned the quarter from a gain to a loss for equities. As stated last quarter, we will continue to monitor these developments and take appropriate action when necessary.

In addition to these events, high-priced information technology stocks took a hit due to their association with Facebook. Growth-oriented stocks, like the technology leaders in the highly-touted FAANG group (Facebook, Amazon, Apple, Netflix, and Google), had led the S&P higher into 2018, but the news coverage regarding the invasion of user privacy at Facebook sent most of these stocks down in March along with the tech sector as a whole.

While there is little indication, based on the various leading and contemporaneous measures of economic performance, that the economy overall has been negatively impacted by these events, the decline in Treasury bond yields during March once again signaled that fear has risen. Rising interest rates that accompanied strengthening economic momentum had not hurt stocks, and conversely, the recent fall in yields did not help stocks, except the most interest-sensitive sectors.

For more information, please contact:
marketing@skba.com or call 800.969.7852

With Jerome Powell newly at the helm of the Federal Reserve Board, the impact of monetary policy shifts are being hotly debated. We remain in uncharted territory in terms of the potential impact of rising short-term interest rates after eight years of the Fed's zero interest rate policy. Powell appears to be on the same course as his predecessor Janet Yellen with plans to raise the Fed Funds rate at least two more times in 2018 and again in 2019. The normalization of short-term rates back to or above 2.5% does not, in and of itself, pose a danger for economic growth. But as we've seen with corporate borrowing and imbedded leverage in market investments like VIX shorting, the pace of change could be disruptive to markets and perhaps the economy even if higher interest rates ultimately reduce excessive risk taking.

This increase in troublesome events in the stock market's calculus of future trends has recently driven the stock market down, and at the same time, the decline has seemingly wiped out the perceived benefits of tax reform. These benefits have not gone away, and if an all-out trade war is avoided, today's weakness will turn into tomorrow's strength. Although caution is warranted, we have not overreacted to the market's concerns by making radical portfolio shifts. Rather, we have continued to focus on reasonably valued companies with improving fundamentals over our time horizon.