Review & Outlook – 1Q 2018

Normalcy finally returned to equity markets in the first quarter, ending nearly two years of calm and leaving investors feeling unsettled. January started much the same as 2017 ended, with equity markets advancing relentlessly and extending the historic period of low market volatility and length of time without a double-digit decline. Returns in the first month were so strong, a new phrase was coined to describe it, a "market melt-up".

February and March shattered the illusion of tranquility, first in early February when stocks declined more than 10% on fears of a return of inflation and then again in late March as concerns of a "trade war" with China rattled market participants. The S&P 500 ended the quarter down just 0.8% but the 23 daily moves of greater than 1% over those 3 months, compared to just 8 such days in all of 2017, contributed to a feeling that returns were much worse.

Market volatility is always nerve-racking but it is helpful to put the daily market action in perspective and to see them as opportunities for the long-term investor. As we have been writing for some time, intra-year declines of 10% or more occur almost annually, even in rising markets. Last year's relative calm was an anomaly, not the declines in February and March. Despite the negative performance year to date, the S&P 500 still returned an impressive 14% over the last 12 months and 10.5% per year for the last 3 years.

Placing short-term declines and worries in a proper context does not mean ignoring the cause of the decline. Concerns about the negative economic impacts of tariffs and the possibility of retaliation, particularly from China, leading to further escalations and policy missteps are very real. However, the tariffs announced by the end of March and China's initial retaliation are expected to have an economic impact of about $36.5 billion, compared to the nearly $800 billion in expansionary fiscal policy expected from the recently passed tax cuts and spending bill.

The market seems to be pricing in the worst-case scenario regarding trade and tariffs while ignoring or downplaying the stimulative tax and spending policies. The data continue to show a strong underlying economy: unemployment is close to 4%, consumer confidence is high, wages are growing (from a low base), GDP should grow 3% in 2018, S&P 500 earnings are strong and companies have started to announce repatriation plans for cash held outside the U.S. Valuations which looked somewhat rich at the start of the year now look very reasonable. The S&P 500 trades at 16.4x forward earnings, just above the 25-year average of 16.1x.

Outside the U.S., the MSCI EAFE index of developed markets declined 1.6% in the first quarter while the emerging markets index increased 1.3%. In the Eurozone, 2017 GDP growth was the highest since 2011 and unemployment fell to 8.6%, a post-recession low. Angela Merkel was reappointed to another 4 year term, eliminating some political uncertainty and giving her the opportunity to work with French President Macron on EU reforms. Japanese data are also encouraging as GDP grew 2% last year, wages are growing and inflation seems to finally have returned. The Japanese Central Bank has even discussed ending its expansionary monetary policy in 2019, though globally monetary policy remains accommodative and will remain so until at least next year.

Equity market volatility reverted back to normal in 2018, delivering the overdue double-digit pullback and finishing over 20 days either up or down 1%. Volatility, no matter how typical, can always be scary and underscores the importance of our focus on diversification and a long-term investment horizon. Diversification maintains exposure to a variety of asset classes and market sectors and is both an aggressive and defensive strategy, smoothing returns over time. Our long-term focus allows us to avoid sudden portfolio changes based on short-term volatility and to not become excessively optimistic or pessimistic. Now is a time to remain patient, disciplined and aware of the opportunities volatility offers.