Congress Wealth Management

First Quarter 2018 Investment Commentary

During the first quarter of 2018 the market experienced very solid corporate earnings, a steady stream of improving economic fundamentals, several wild bouts of volatility, and not much in terms of investment return. The equity markets basically went straight up in January and straight down much of February and March. It's only a three-month period but the truth is that after a very slow and steady 2017, so far 2018 looks very little like last year. The data remains very good but when it comes to volatility, we've had a return to normalcy.

For the first time in a long while both the equity and fixed income markets suffered negative returns for a calendar quarter. In the U.S., the S&P500 index posted a return of -.8% in the first quarter as the utilities, telecom, and energy sectors all underperformed the broad market. International markets reflected similar mixed results; developed market equities were down -1.4% while emerging markets were up +1.5%. Returns in the fixed income market was equally difficult to come by as higher yields pushed bond prices lower. The Barclays U.S. Corporate Bond Index was down -2.4% in the first quarter while the municipal bond index was down -1.6%. Within the credit markets there were few, if any, places to hide. The "synchronized global growth" story we have been telling for the past year and a half has now been met with higher yields, and such will likely be a headwind for traditional fixed income portfolio returns going forward.

We spend a lot of time here at CWM analyzing, discussing, and communicating our thoughts on where we think we are in the economic and investment cycle. Ours is an institutional approach to asset allocation that is based on data. Data tells us where we are in the cycle, where risks and opportunities lie, and identifies inflection points when asset allocation should be altered. Data is more reliable than hunches, intuition, and anyone's best guesses on near term results. Data is unemotional and unattached. Data doesn't let you leave market cycles too early or, more importantly, stay too late. But focusing on data also requires discipline and respect for the data and its trends. As such, phrases like "this time it's different" aren't allowed in our vocabulary. In our mindset, data is data.

Within this framework, we have a specific list of what we consider to be the "Things that Matter". We purposefully communicate our thoughts on this list with our clients often. Here's an update on that important list:

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"Personal" economy: By "personal" economy we mean things like job creation, wage growth, consumer sentiment, and housing. Things that all of us experience every day as participants in the broader economy. We believe the "personal" economy remains in excellent footing. In the U.S., the labor market is adding about 100k-200k jobs per month and the participation rate is growing for the first time in six years. Wage growth remains below average but is trending upward. Consumer sentiment remains high and spending robust. The inventory level in the auto sector is probably too high for demand, but housing remains sound and housing inventory levels nationally are below average. Household debt service levels remain in check.

"Business" economy: We believe the best two measures of the "business" economy are the survey data released by the Institute of Supply Management (ISM) and the Purchasing Managers Index (PMI). These surveys collect data from companies on their business activities such as production, orders, inventories, manufacturing employment, etc. These are both indexes where the line of economic growth is drawn at 50: a reading of above 50 reflects economic expansion while below 50 reflects economic contraction. The ISM reading now resides at 59, its highest reading since the financial crisis, while PMI readings are noting a broad-based pickup in business activity globally.

Corporate earnings: The pick-up in the personal economy and the business economy is leading to improving revenue trends and that revenue growth is being translated into earnings growth. Earnings growth in 4Q17 was approximately +15% and estimates for 1Q18 corporate earnings growth are in the range of +15% to +18%. For FY18, earnings per share on the S&P500 will be approximately $152, up around +11% YoY. Similar earnings growth is now being forecast into FY19 earnings. Ultimately, as the economic cycle matures earnings growth will naturally stagnate. We are not seeing signs of that presently.

Credit markets: Bonds have two components to their yield: the risk-free yield as measured by the corresponding US Treasury rate and a credit spread, which is assigned by the market as an indication of credit-worthiness. Credit spreads in both the investment grade and high yield bond market remain both low and stable. The Fed has clearly embarked on a multi-year task of raising the Fed funds rate. We will likely get four to five rate hikes over the next two years. This will flatten the yield curve and tighten credit conditions. Currently, the Treasury curve has a slope of 50bps between 10y and 2y Treasuries. That curve will eventually flatten and likely invert. Such an event will be a major signaling point as to where we are in the economic cycle but, at present, the likelihood of an imminent recession remains very, very low.

"Flow of Funds" data: The funds flow data we look at from both ICI and EPFR continues to tell the same story: steady flows into bonds and out of stocks. Since 2009, more than $1.7 trillion has gone into bond funds and exchange-traded funds (ETFs) while approximately $500 billion has come out of U.S. equity mutual funds and ETFs. That is <u>not</u> how a bull market ends. Two other big bids exist within the market. U.S. corporations have been buying back their stock at a pace of about $500 billion per year. Following the changes to the U.S. tax code last December, the level of stock buybacks is expected to increase to around $800 billion in 2018. Similar high levels of liquidity exist within the private equity markets where more than $1 trillion has been committed for private equity funds but to date is unfunded. In a world where interest rates remain very low, way too much capital is trapped earning close to nothing. Our belief is that this capital will be deployed as we make our way through the latter stages of the economic cycle, a cycle which we believe will be far longer than average due to the extraordinary levels of available liquidity.

<u>What does the compilation of this data mean?</u> In our mind it means the bull market has further to go. Economic activity, earnings growth, and unprecedented levels of liquidity are the underpinnings of this bull market and they all remain firmly in place. Ultimately, what ends the bull market in stocks and what slows the economy will be aggressiveness of the global central banks. As the economic cycle progresses, economic growth will lead to inflation. The global central banks will be forced to raise interest rates and contract credit to a point that economies will slow. This task is made more difficult this time around because central banks will be raising rates <u>and</u> trying to undo trillions of dollars of asset purchases. Here in the U.S. the Fed has started to slowly shrink its own $4.5 trillion balance sheet. This unwinding by the Fed will be a very slow process, one that might take a decade to complete. Globally, both the European Central Bank and the Bank of Japan continue to actively pursue quantitative easing, keeping their benchmark interest rates well below historical levels by making open market purchases of all forms of credit. Monetary policies in these markets may change starting in late 2018 or early 2019. By late 2019 we will no longer be talking about "global quantitative easing" but rather "global quantitative tightening". "QT" will be the new catchphrase – you heard it here first. We'll be monitoring and communicating our thoughts on this as it develops.

Our sincere thanks to all our clients for your continued trust.

Richard J. Barrett
Chief Investment Officer
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