Quarterly Market Outlook

April 2018

Volatility is Back

After one of the calmest years on record, market volatility surged in February and March. During all of 2017, there were only 8 daily moves greater than +/- 1% in the S&P 500. In the first quarter of 2018, there have already been 24 moves of this magnitude.[1] Several factors are driving the increase in risk: high valuations, tightening monetary policy, and the threat of trade wars.

Late Cycle Dynamics

The first quarter represented a shift in market dynamics that is typical of the later stages of the economic cycle. While global growth remains strong, traditional asset markets are facing headwinds associated with tightening monetary policy as central banks shift from supporting growth to normalizing interest rates. Both stocks (MSCI World) and bonds (Barclays US Aggregate) were down over 1% during the first quarter.[1] In contrast, commodities such as oil and gold have been among the strongest performers in 2018.

Rising Interest Rates

The Federal Reserve increased the Fed Funds rate by another 25 basis points in March, taking the current rate to 1.50-1.75%. Based on recent "dot plots" from Federal Reserve governors, the Fed expects to raise rates two more times this year, which is roughly in line with market pricing. Strong growth and emerging inflation pressures are driving up long-term interest rates as well, resulting in negative bond performance. Unlike past market downturns, traditional bonds have not offered much diversification this year.

Rising Oil Prices

Oil prices have continued to rise this year, with prices approaching $70 per barrel, up over 50% since the lows last summer.[1] Other industrial commodities have been rising as well, creating additional inflation pressure. We believe the supply/demand dynamics of commodities to be favorable going forward and recommend that clients consider increasing their exposure.

Tensions Ease on the Korean Peninsula

In March, the leader of North Korea, Kim Jung Un, reached out to President Trump with an offer to meet, which Trump quickly accepted. In April, Kim Jung Un and South Korea's President, Moon Jae-in, met in Seoul; the first face-to-face meeting between the nations' leaders in eleven years. This has served to de-escalate tensions on the Peninsula in the short term, but negotiations around North Korea's nuclear program are likely to be complicated. While this marked an important positive development politically, the threat of trade wars has dominated recent market reaction.

[1] Source: Bloomberg.

Trade Wars

President Trump carried through on his campaign promise of being tougher on China by proposing tariffs on over $150 billion of Chinese imports. China quickly retaliated. While it is unclear how much of this is a negotiating tactic from the Trump administration, markets have reacted negatively to the potential for an escalating trade war. Trade wars are likely to be inflationary (since goods are more expensive than they otherwise would be) and are generally negative for global growth in aggregate (though there will be winners and losers).

Fiscal Stimulus in the Late Cycle

The recent tax cuts are projected to add over $1 trillion to the U.S. fiscal deficit at a time when the economy is already growing above potential. It is unusual to engage in a large fiscal stimulus package 9 years into an expansion with unemployment at cyclical lows. As a result, the stimulus is likely to put upward pressure on inflation and interest rates. Ironically, this may bring the next recession sooner as rising interest rates lead to a repricing of financial assets.

Populism and Limited Ability to Ease are a Dangerous Combination

The next economic downturn will present unique challenges due to limited monetary and fiscal levers. With interest rates and bond yields close to zero, additional monetary easing is likely to be less impactful. From a fiscal perspective, the U.S. already enacted a large stimulus package, which makes additional fiscal stimulus less likely. To further complicate matters, growing wealth inequality is leading to more nationalist/populist sentiment among world leaders, which will make it more difficult for them to work together to solve common challenges during the next recession.

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