PENNIALL PERSPECTIVE

April, 2018

"Global growth is on an upswing, but favorable conditions will not last forever"
-International Monetary Fund (IMF)

Economic & Market Summary

Momentum from recent tax reform and positive earnings reports helped jumpstart markets, pushing many major indexes to new record highs to kick off the quarter. As the quarter wore on, however, concerns over future Federal Reserve policy and budding inflation ultimately took hold, pulling markets sharply lower. Discussion of a trade war between the U.S. and China added to investor wariness. Volatility increased, interest rates rose, bonds fell, and, aside from a modestly bright spot in emerging markets, most stock indexes ended the quarterly slightly lower than where they started.

Bull Case

Economically speaking, last year we experienced synchronized, stronger-than-expected global growth which has continued into the first quarter of 2018. Emerging market economies benefited from the rebound in commodities, developed international economies showed strength, and the U.S. enjoyed an extra boost from recent tax reform. The result was the fastest pace of economic growth since 2011.

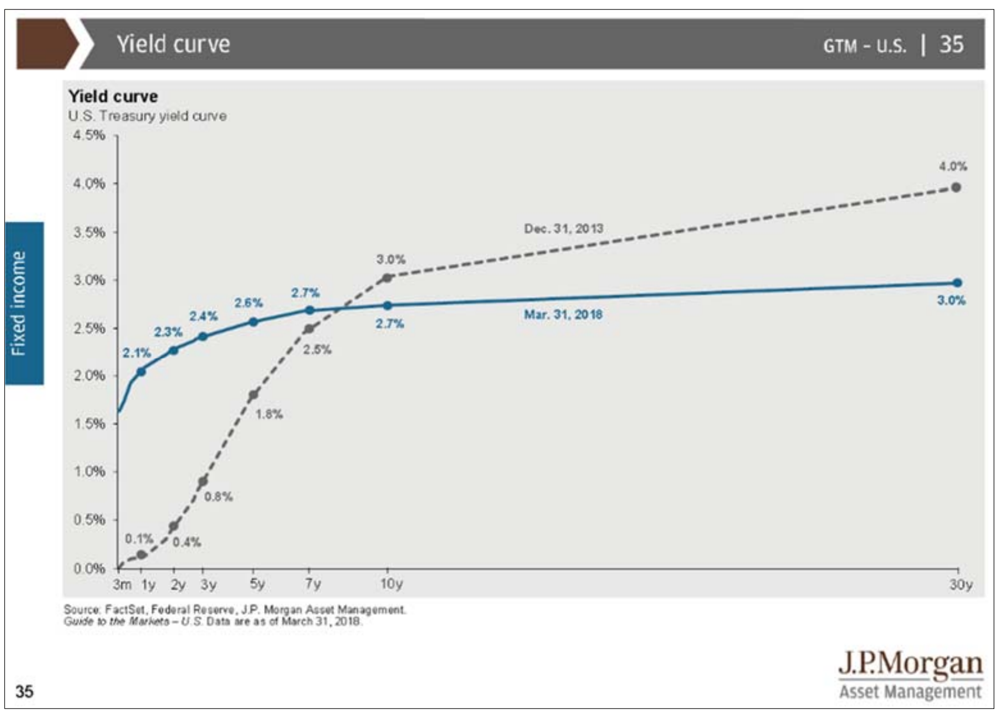
U.S. tax cuts have some investors reminiscing of the Reagan era… Lower taxes will stimulate economic growth and interest rates will rise slowly, steadily, and healthfully as companies compete for funds. Low unemployment and steady job creation suggest wages are going to rise and, ultimately, inflation will start to pick up as well. And, even though the current recovery has been going on for many years, many in this camp argue we are nowhere near a state of economic overheating, so this scenario may extend for years to come. Are there risks out there? Yes, and we will get into those below… but there is a real argument that none of these risks are imminent, that growth is stable, and that we should ride the wave of economic expansion while it lasts.

Finally, there is lots of discussion surrounding high current stock market valuations. Valuations are metrics that compare the price of a stock or index to underlying growth of that same stock or index. Common examples include the P/E (price-to-earnings) ratio, price-to-sales ratio, and book value per share. Across the board, valuations for US stocks are high, meaning stock prices are higher than underlying growth. Historically, periods of high valuations are usually followed by periods of lower valuations, which happens by either the stock price falling or underlying growth increasing. There is another, indirect input to these metrics, however, and that is interest rates. Low interest rates make it possible and actually quite reasonable to have valuations above long-term averages, a scenario that economically makes sense and has played out in other historical low rate environments. Given the entire picture, valuations aren't quite overshot as they initially appear.

Bear Case

As a counterargument to those who believe we are entering another Reagan-type era, let's consider the significant differences in today's environment compared to the early 1980's. For one, the Reagan tax cuts came after a severe recession, not nine years into an economic expansion. So, the economic growth and prosperity that followed had an added tailwind of following a period of suppressed markets and a beaten down economy. Secondly, the debt ratio was 35% at that time, a far cry from the 105% as of late. There is empirical evidence to suggest that economies with debt ratios above 90% find robust economic growth impossible to attain. In part, this theory suggests that resources get siphoned away servicing debt rather than investing in growth, so growth simply cannot take off.

Looking beyond the minimal impact of U.S. tax reform on long-term economic growth, perhaps the greatest danger for today's market is the trade conflict between the U.S. and China. The detrimental economic impact of tariffs and increased barriers between two global powerhouses is serious and likely to have a trickle-down effect on the global economy. More problematic is the behavioral risk of investors and consumers overreacting to headlines and sidelining cash. As the International Monetary Fund (IMF) stated in their recent press release, trade wars may "harm market sentiment, disrupt global supply chains, and slow the spread of new technologies, reducing global productivity and investment." Such behavior could extend the impact of this conflict well beyond soybeans and technology into virtually every corner of worldwide markets.



Another problematic indicator is the behavior of the interest rate or yield curve. The yield curve is a chart with different maturities of the bonds on one axis and the rates on the other (see chart). Conceptually, steep yield curves are indicative of thriving economies (bondholders are justifiably paid more for holding longer maturity bonds) and flattening or inverted (downward-sloping) yield curves signal struggling markets. As short-term rates have risen and long-term rates are largely unchanged, the current yield curve has flattened – a stage before inverting. Only time will tell if this worrisome trend will continue into a full-fledged inverted curve.As a counterargument to those who believe we are entering another Reagan-type era, let's consider the significant differences in today's environment compared to the early 1980's. For one, the Reagan tax cuts came after a severe recession, not nine years into an economic expansion. So, the economic growth and prosperity that followed had an added tailwind of following a period of suppressed markets and a beaten down economy. Secondly, the debt ratio was 35% at that time, a far cry from the 105% as of late. There is empirical

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Conclusion

Global growth continues, but we continue to question how long it can last, especially given valuations and global trade issues. On the other hand, many metrics of economic data suggest the environment is stronger today than in quite some time and perhaps we have several more years of expansion before the inevitable rollover. In the words of the IMF, "global growth is on an upswing, but favorable conditions will not last forever." Only time will tell exactly when these "favorable conditions" will come to an end. In the meantime, we continue to encourage our clients to focus on their long-term financial goals rather than the inevitable ups and downs of short-term markets.