



Will Trade Wars, Military Strikes & Rate Hikes End the Bull Market? April 2018

Dear Client:

For the better part of two years, markets have stayed remarkably tranquil. But that calm ended abruptly in the first quarter of 2018 when volatility returned to the market with a bang. The S&P 500® Index gained or lost more than 1% on a daily basis 23 times. Market participants faced apprehension on many fronts – the lateness of the economic cycle; the potential impact of massive increases in U.S debt; complacency in market positioning (structural or explicit short volatility bets); inflation; Fed rate hikes; military action in Syria; potential conflicts in Iran and North Korea; global trade wars fueled by U.S. tariffs; and the ending of trade agreements (NAFTA). After leaving a trail of protectionist breadcrumbs via Presidential tweet, the U.S imposed a 25% tariff on imported steel and a 10% tariff on imported aluminum as an attempt to penalize China. These factors combined to whipsaw the US markets and heighten investor angst.

While volatility swayed daily returns, in the first quarter of 2018, the broad U.S. equity market (as measured by the MSCI USA IMI Index) only declined by 0.61%, and the large-cap focused S&P 500® Index slipped 0.76% for the full quarter. The quarter marked the first time since the third quarter of 2015 that the two indexes both posted quarterly losses. Based on MSCI USA indexes, mid-capitalization stocks fared better than both small- and large-cap stocks, and growth-oriented stocks outpaced their value-oriented peers across the market capitalization spectrum.

Only two of the 11 economic sectors within the S&P 500® Index (which provides a proxy for the equity market) posted gains in the first quarter: Information Technology and Consumer Discretionary. Amazon, Netflix, and lower personal income taxes were all factors in boosting the expected outlook and quarterly performance for these two sectors. Increased consumer spending and consumer confidence for the quarter while positive may also be further confirming of a broader market peak. Conversely, the Telecommunication Services and Consumer Staples sectors posted the biggest losses.

International Equity Markets



International equity markets posted mixed returns in the first quarter. International developed markets, as measured by the MSCI EAFE Index, declined 1.53%(net of taxes). Emerging equity markets, as measured by the MSCI Emerging Markets Index, fared better than developed equity markets, gaining 1.42% (net of taxes) in the first quarter 2018. Fears of military withdrawal and then an escalation in action in Syria caused confusion and tension. Further tough talk regarding Iran, and as North Korea, combined with changes in the U.S. State Department and the third National



Security Advisor, in less than 18 months created further global uncertainty on policy direction on top of the trade threats.

Bond Market

Bond markets posted mixed results in the first quarter, with most major indexes and sectors posting losses. The broad U.S. bond market, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, declined by 1.50% in the first quarter. Shorter-duration maturities fared better than longer-duration maturities. The yield on the benchmark 10-year U.S. Treasury note ended the first quarter at 2.74%, up from 2.40% at the end of 2017. Yields in the \$14 trillion market for U.S. government debt touched record lows in 2016, driven by years of aggressive central bank intervention in the wake of the 2008-2009 financial crisis to keep interest rates low and to stimulate the economy. This quarter's strong upward move in yields from those historic lows was reinforced by a Fed rate raise in March, all seeming to confirm that the new trend in rates is ...UP.

Today, investors are grappling with the effects of prolonged rate increases for the first time in nearly 10 years. The Federal Reserve is strongly indicating the possibility of raising interest rates three times this year. It is staying on the schedule it revealed last fall, and this quarter the agency is reducing its balance sheet by \$30 billion per month (\$18B Treasuries and \$12B Agency bonds). Furthermore, some economists are predicting that the European Central Bank will start to raise rates later this year.

The combination of massive budget deficits and inflationary pressures and has become the hot topic this year on bond-market trading floors... so much so that "bond vigilantes," a retro term not heard in two decades has re-appeared in market vernacular. Back in the 1980's Ed Yardeni, who is now the president of his namesake research firm, coined the phrase "*bond vigilantes*." He used the term describe to activist investors who were demanding higher and higher yields as compensation for the perceived risks of inflation and budget deficits inherent in owning U.S. debt in 1980s. Thus, whether intentional or unintentional, these bond vigilantes showed that the bond market can be used to serve as a restraint on the government's ability to over-spend and over-borrow. While it is still early, if 10-year yields reach and aggressively pass 3%, we might just see the re-emergence of bond vigilantes.

First Quarter Review



The current fiscal policies of the White House, Congress, and the Fed will likely exacerbate concerns about ballooning deficits. Which I think offset the benefits lower corporate tax rates in the U.S. have on U.S. equities. Expect the tax plan to be political gamesmanship in the upcoming election season, with both sides claiming victory and using it to defeat the other. While budget deficits and inflation threats are market driving dynamics, one factor that is gaining investors' attention, is the growing potential of trade wars During the quarter, the administration announced tariffs on steel and aluminum imports. Beijing immediately responded by surgically targeting billions of dollars in tariffs on U.S imports many of which are grown or



manufactured in states that the President won during his 2016 election. The world, under U.S. leadership, has built an interconnected global trading system over the past several decades. The ties are deep and complex, and they are not likely to be dismantled in the short-term (or perhaps over the term of one administration). Now, however, markets are clearly worried about the prospects for trade policy and repercussions. As with many of the policy actions from the current administration, it is extremely difficult for investors and citizens to discern the difference between a negotiating tactic and a ploy for news cycle attention, and almost impossible to envision an actual policy goal or a likely result. If the market begins to fear serious retaliatory trade concerns, both stocks and bonds will suffer. Restrictive trade policy can lead to stagflation (reductions in output and increases in inflation) and ultimately recessions.

A Look Ahead



During the remainder of the year, numerous political concerns are likely to place new pressures on the markets. As always, political and geopolitical concerns pose serious challenges for asset allocators. I believe that taxes and the threat of combat are the two most hot-button issues. First, the moves toward a territorial tax system (repatriation) might be a long-term net positive for U.S. corporations. Also, lower tax withholding rates for will probably help the U.S. consumer continue to improve their balance sheets.

Second, while positive steps toward negotiations over North Korea look like they could come to fruition, other hot spots have arisen. “Uncertainty” is absolutely the correct term to describe U.S. global policy. Many regions of the globe pose the potential to disrupt markets during 2018. Issues will likely arise in a sudden and unpredictable fashion.

On a brighter note, we have been in a synchronized global recovery for the past few years. Shorter-term indicators of macroeconomic health (consumer and business sentiment; high frequency unemployment claims) leave very little concern about near-term downturns in economic activity in the U.S. I am on the alert for changes to those high frequency data points – rising household debt among the bottom 80% and the slowing of domestic car sales are two early indicators to remember for future reference. However, right now, there is no cause for alarm.

As I expected, 2018 has so far looked like a more sobering year than 2017. Risk factors seem to be lining up to express themselves quickly, loudly, and abruptly. I want to emphasize tighter risk management as a possible critical factor in how investors will navigate an aging bull market and economic cycle. The tax cuts while giving U.S. equities a tailwind into this year have also added to the national debt and are among numerous risk factors at play as 2018 unfolds.

Focusing on the long-term and paying some attention to the medium-term risk factors could help foster a more successful navigation of 2018’s economic noise.



Achieving long-term outcomes requires a combination of maintaining focus and perspective, while also heeding changing conditions that transition a trend into the new baseline market environment. Thus, my portfolio considerations now, like last quarter, are cognizant of risk management as the period of multi-year gains are very likely behind us. Consider that risk is now growing with the re-emergence of volatility and examining your portfolio asset allocation targets should be at the top of your to-do list. I would suggest consideration of the following portfolio actions:

1. reduce U.S. equity holdings to target;
2. consider lowering overall U.S. equity allocation;
3. continue to use gains in U.S. equities for liquidity needs;
4. maintain a slight allocation tilt towards emerging market equity and away from U.S.;
5. favor small caps versus large caps, be they at home or abroad;
6. short duration and floating rate bonds are favorable;
7. rebalance portfolios to hold cash from gains and increase your margin of safety;
8. seek out selected niche and special illiquid private investments;
9. consider tilting to U.S. value stocks versus U.S. growth stocks.

As we approach summer, this quarter provides an opportune time to review your asset allocation along with your financial objectives and goals. Continue to evaluate your risk tolerance, circumstances, and time horizon as markets trend and then change quickly. Let's discuss in our upcoming reviews if any changes are needed or if we still have a suitable plan in place for you. As always, it is a pleasure to serve you, and I look forward to continuing to work with you toward achieving your investment goals.

Appreciatively,

Walid L. Petiri

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