Trade-war fears drive volatility. Fundamentals Remain Solid.

By Daniel Wildermuth

After February saw the market drop 10% in 10 trading days followed quickly by almost a complete recovery, March has continued to hit investors with volatility. During the third week of March, the market lost 5.6% from Monday's opening to Friday's close, delivering investors the worst trading week in more than two years. The losses left the market down more than 10% from its January all-time high. While indices sharply rallied the following Monday (March 26th), Tuesday's sharp reversal gave back nearly all of the day's previous gains.

Recent losses have resulted from increased fears that the U.S. will start trade-wars, particularly with China. Adding or increasing import tariffs has an abysmal track record. The Smoot-Hawley Tariff that greatly contributed to the Great Depression provides the most notable example. If Trump were to unleash a trade war, the economy would slow, inflation would increase, and stocks would likely plummet. Hence, on the day President Trump unveiled plans to impose new tariffs on up to $60 billion worth of Chinese goods, the Dow Jones plunged over 700 points followed by losses of nearing 500 points the following day.

How justified is the fear? After the initial drop on trade war fears, markets quickly bounced back as the U.S. and China both indicated willingness to negotiate on tariffs rather than go to war. The approach and result all seem very familiar. Renegotiating trade packs he views as unfair has always been a Trump priority. Trump's tactics of renegotiating individual deals with countries or blocks of countries follows the standard approach used by essentially all world leaders. But, his loud and public tactics combined with a more confrontational style are uniquely Trump. Investors are still adjusting. In the end, his results have been fairly typical. Friction over the NAFTA trade deal largely came and went. Talks with China are already moving ahead, and a deal with South Korea was made in late March to avoid steel tariffs.

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World markets seem to have the same view. The clearest current beneficiaries of global trade are Germany, Japan, South Korea and Singapore. During the recent U.S. induced trade spat with China, the stock markets in all these countries outperform the S&P 500 in dollar terms. Surprisingly, all of these markets are also beating the S&P 500 since Trump's November 2016 election. Investors do not seem to believe a global trade war is coming.

Forecasters surveyed in late March by The Wall Street Journal are also more optimistic. As a group, they expect solid economic growth in 2018, but also project that growth may not meet expectations. Notably, trade policy and protectionism were highlighted as risks to the outlook with additional comments highlighting the potential of politics to cause problems.

Internationally, the eurozone enjoyed its best year in a decade during 2017. Unemployment within the region has fallen to its lowest level since late 2008, but wage growth continued at a slow pace keeping inflation down but fueling voter dissatisfaction. Europe finally is enjoying real economic progress, but fears remain that voters may usher in leaders with very poor policies that undo recent gains or worse.

China's growth increased to 6.9% in 2017 ending a slowing trend that began all the way back in 2011. Strong exports led the way – likely contributing to Trump's tariff threats referenced earlier. While China's official nonmanufacturing Purchasing Manager's Index fell to a

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four-month low of 54.4 in February, all sub-indexes remained above the 50 mark, signaling growth. Although the accelerated expansion is not expected to continue, the Chinese government pledged continued support for the economy through its ongoing shift to higher quality development, and Chinese growth should contribute to the strong, ongoing global expansion.

The real issues facing investors likely lie elsewhere. Rising interest rates, a tight labor market and increasing inflation all could constrain future growth. Some combination of these events probably will provide the trigger for the next significant economic slowdown or recession. The challenges do not appear imminent, but rising rates and an unemployment rate already approaching 4% suggests that problems could arise quickly.

The most significant longer-term issue likely stems from rich equity valuations as mentioned in previous newsletters. While equities could certainly deliver decent returns over the next decade, current prices suggest a target of around 5-7% is more appropriate, and many would argue for lower expectations.

A quick review of the cyclically adjusted price earnings ratio (CAPE) provides more insight. The CAPE ratio is a widely accepted measure of valuation that has a good track record at predicting longer-term returns even if its short-term record is mixed. Some are arguing that today's high levels are justified because higher earnings growth rates will support a permanently elevated CAPE. Essentially, the claim is once again, "It's different this time."

The CAPE ratio results from dividing stock prices by a company or index's 10-year average earnings. Typically, the CAPE ratio bounces between 16 and 20. Today it sits at 32. The U.S. CAPE ratio has reached this mark only twice – in 1929 before the market crashed and during the market run-up in the 1990s that preceded the dot-com crash. While anything is always possible, it seems likely that less favorable conditions resulting from lower GDP growth, higher interest rates, or something more severe such as a recession would move the CAPE ratio back towards its mean. Moreover, even if the U.S. CAPE ratio remains elevated for an extended time, future returns seem likely to fall well below those enjoyed during the last decade because the ratio will not increase indefinitely. It could also be argued that similar factors that are driving the high U.S. CAPE ratio should be impacting international markets, yet most developed and emerging market CAPE ratios remain well below the U.S., again suggesting that U.S. markets are overvalued.

Still, near-term prospects remain solid. The President's tax cuts and regulatory reforms should further enhance the U.S. economy and trade-war fears are likely overblown. The lack of concerning data arising from economic fundamentals and leading indicators suggests that the most recent volatility is just a typical correction. Yet, recent declines and jumpier markets suggest that there is greater awareness of risks to the market, particularly given today's high prices, and the recent pullback has blown off some of the market's froth. Volatility seems likely to continue and it is probably wise to temper long-term market expectations given valuations. The present uncertainty seems more normal and sustainable than last year's surreal steady, uninterrupted climb, and choppier markets will likely remain throughout the year.

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