A Tale of Two Markets

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SUMMARY

• Volatility returned in force in the first quarter of 2018 and both stock and bonds posted negative returns, making for a challenging quarter for investors

• Investors are watching for signs of inflation as unemployment hits new cycle lows

• Economic indicators and corporate earnings remain strong, supported by a still accommodative environment and tax cuts

The resurgence in market volatility in the first quarter of 2018 had many investors turning the calendar on March 31st with trepidation. Returns in the fixed income and equity markets for the first three months of the year were modestly lower but the “roller coaster ride” that led to those returns strained investors. It is a fairly infrequent occurrence to have both bonds and stocks produce negative returns for a full quarter. It is also not often, especially over the last two years, that investors must endure a gain or loss of one percent on almost 30 percent of the trading days in a quarter. However, it appears as though the extreme volatility has subsided (for the time being) and the current market environment of positive domestic economic data remains steady.

The initial report of real GDP for 1Q showed an increase of 2.3 percent after climbing 2.9 percent in the prior quarter. A separate Labor Department report showed that employment costs rose more than expected in the first quarter and private wages had the biggest annual gain since 2008. Consumer spending, the biggest component of the economy, increased 1.1 percent, matching estimates and marking the smallest gain since 2013.

Corporate earnings have far exceeded expectations in the first reporting period since the passage of the Tax Cuts and Jobs Act. Almost 450 of the reporting companies in the S&P 500 index have released 1st quarter 2018 earnings. Of those, 81 have surprised to the upside on an earnings-per-share basis with approximately 86 percent reporting positive growth. The overall average earnings growth rate was 23.5 percent with energy, information technology and financials the top performing sectors.

The employment picture continues to steadily improve. The jobless rate fell to 3.9 percent from 4.1 percent a month earlier. Employers added a total of 164,000 jobs and have created an average 200,000 jobs a month this year, up from last year’s average gain of 182,000. The most recent employment report also showed average hourly pay has grown by 2.6 percent over the past year. The labor force contracted month over month but has grown by 1.3 million from a year earlier. Market participants continue to watch for signs of wage pressures that could drive inflation as unemployment has now reached its lowest level since 2000.
To that point, inflation has moved above “trend” as of late. The employment cost index, a part of the GDP report which includes wages and benefits, rose 0.8 percent from the previous quarter. Despite a softer-than-expected monthly increase, April headline CPI edged up to 2.5 percent while core CPI held steady at 2.1 percent. Meanwhile, a key inflation gauge watched by the Federal Reserve, core PCE, rose at the fastest pace in more than a year. Both headline and core PCE inflation matched consensus expectations. Over the last 12 months, core PCE accelerated to 1.9 percent. The uptick largely reflected base effects as a monthly decline last March fell out of the equation. Still, the measure is now on track to hit the Fed’s 2 percent target supporting continued rate hikes going forward.

Heading towards fiscal year-end, like Charles Dickens, we might conclude “that it was the best of times and the worst of times.” The first half of the fiscal year 2018 treated investors to excess returns in a surprisingly low volatility environment while the second half, so far, has made any incremental portfolio gains a test of will. However, as investors reassess the risk profile of the overall portfolio, it is important to recognize that the accommodative policies put in place during the crisis, along with the Tax Cuts and Jobs Act have laid a foundation for stronger domestic economic growth that will likely play out for the remainder of 2018. As a result, we believe that there are still good, if not best of, times remaining for 2018.

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