market news

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"Back to the Future"

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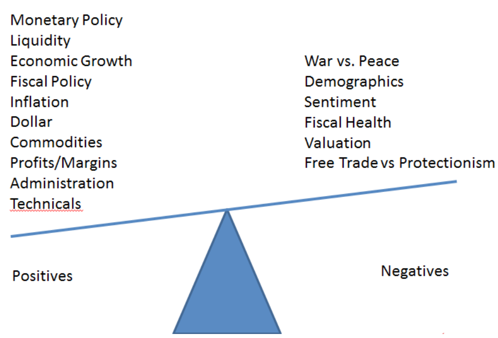
It is that time of year when investment advisors are compelled to write their annual market outlooks, something perhaps only their mothers enjoy reading. The good news is the markets had a very good year so perhaps I have a little less pressure than in other years. Nonetheless, there is a certain challenge to attempting to predict the future without the help of a DeLorean powered by a flux capacitor.

For many years, the worries of the market have focused on whether the economy could recover and move beyond the financial crisis. Rising interest rates, labor market tightness, inflation and even the business cycle have seemed like tales from the past. The current environment is likely to present some challenges to investors as we appear to be at an inflection point where these forgotten conditions begin to reappear and as the market relearns how to manage these worries.

To make good decisions during this period of transition, we will need to look back in history to provide perspective on the future. Looking through this lens, we are likely returning to a period of more historically normal economic and market volatility. This shifting environment out of a period of quantitative easing and extraordinary monetary policy brings with it a somewhat different set of challenges and opportunities than those of the past.

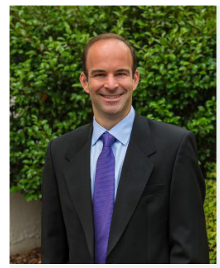
To evaluate the current investment environment, we analyze the answers to two basic questions. First, *are economic conditions on average good or bad?* Second and perhaps more importantly, *are things getting better or worse?* The answers to these questions are then put into the context of both history and the current economic conditions. The process of mental weighing of the positive and negative aspects of the current conditions compels us to remain objective when assessing investment opportunities.

While by no means comprehensive, the graphic below provides some insight into the calculus of the markets. The balance of these factors will likely have a considerable impact on how the markets move over time. Economically speaking, the environment today is about as good as it has been for some time. While this backdrop does not guarantee positive returns, it certainly does help to have the wind at your back. Looking forward we see several drivers that should continue to support both the markets and the economy.



The Positives:

Monetary Policy, *which refers to the actions of the global central banks*, remains supportive for the markets. At present, interest rates are still at historically low levels. Additionally, the majority of the global central banks are still pursuing quantitative easing measures. We expect the improving economic picture will gradually lead to less accommodative monetary policies as our central bank continues transitioning to a more normal policy and as other central banks around the world perhaps begin this transition. While monetary policy is a potential headwind in the future, we feel it will be some time before it should become a meaningful headwind for investors.



Scott consults with TSWM clients and relationship managers to implement their financial plans through building diverse portfolios of high quality, low cost investments relative to individual goals. Scott helps clients to gain better understanding and peace of mind in a complex and often confusing world. He strives to bring patience and objectivity to the investment process on a daily basis in order to avoid the destructive impact emotional reactions can have on financial decisions. Scott joined TSWM in 2006.

Fiscal policy, *which refers to government actions*, is one of the larger positive changes we expect to see continue in the coming year. The combination of the recently passed tax and jobs act and the pro-business regulatory environment should provide support to the economy at least for the short term. The impact of these pro-growth policies should help minimize any potential negative effects from monetary policy.

Liquidity, *which refers to the availability of capital*, has been very strong and is likely to remain so. The credit markets are functioning very well with spreads at very low levels. Additionally, a relaxing of the regulation around financial companies should positively impact liquidity.

Economic Growth *continues to be strong.* We are in the midst of the first sustained period of global economic growth in many years. This economic backdrop should be very supportive to corporate earnings. Perhaps even more important, there has been a noticeable uptick in business confidence and a certain sense of urgency that has been lacking for some time. This change in mentality could help spur business investment and capital spending further stimulating the economy.

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The **Political Environment** *refers to the administration's attitude toward business.* There has been a significant change in the political environment since the 2016 presidential election. The republican sweep has led to a more business friendly government. While not entirely positive, in general, the administration has been more business friendly. The combination of corporate tax reductions, deregulation and the general pro-business tone leads us to expect continued support for the markets.

A **Weaker Dollar**, *comparable to other global currencies*, is generally a positive for the equity markets. This is helpful for global companies whose goods become correspondingly cheaper for foreign buyers. This leads to an increase in exports which in turn boosts economic growth. While we do not expect a dramatic fall in the dollar, we do think it will remain a relative positive for the time being.

The Negatives:

Valuation *is the relative level of stock market prices* usually measured by the price to earnings ratio. This ratio tends to average around 16 but currently is sitting closer to 20. To put this in context, this ratio reached 35 during the last technology bubble of the late 1990's. While certainly not a bubble, the current level of stock prices likely means that we will need a period of time where earnings outpace stock prices in order for things to end well. Our hope is that this process occurs gradually as stock prices continue to rise, all be it at a more modest pace.

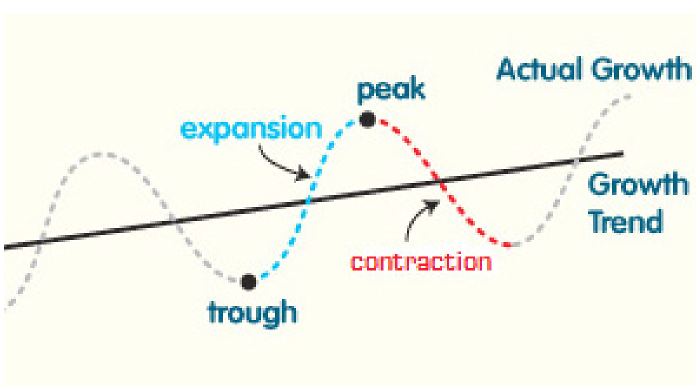
Free Trade and Protectionism *refer to the prevailing attitudes of governments toward trade.* This is one area in which the Trump administration, at least rhetorically, has been less business friendly. The tone taken around the NAFTA negotiations as well as some trade policies enacted have left the market concerned that a trade disruption is a possibility. While a serious trade disruption is not something we expect, especially given the administration's desire to see equity markets rise, the risk of a policy error in this arena is a cause for concern.

Fiscal Health *is the balance sheets of governments around the world.* While corporate and personal balance sheets have improved, those of governments have not. The combination of rising entitlement payments, the costs of the financial crisis and other factors have left governments more leveraged than they have been in some time. Though this is not an immediate cause for concern, it can be something of a drag on the economy over time and make the impact of higher interest rates more pronounced.

The only constant is change:

Prior to 2017, there had been little change in the economic and investment environment for several years. We had many years characterized by slow but stable growth in the U.S. combined with less positive growth abroad. Similarly, interest rates and inflation were very low and central banks were aggressively seeking to stimulate growth. Last year this backdrop began to change. Though this change is pretty unambiguously positive, it does bring with it a new set of concerns for the market.

For many years the economy has grown slowly and steadily around the 2% level. It is likely that the long run sustainable growth rate of the economy is right around this level. Enter the combination of stronger global growth and fiscal stimulus from the tax cut and suddenly we have an economy growing at a higher rate and the plausible return to a more normal business cycle environment with periods of expansion and contraction returning. This is normal and healthy, but since it has been many years since we have seen this type of economic volatility, there will be some people surprised by it. Both investors and the markets are likely to grapple with the return of the business cycle, higher interest rates and possibly inflation in the coming years.



J.P. Morgan, Guide to the Markets

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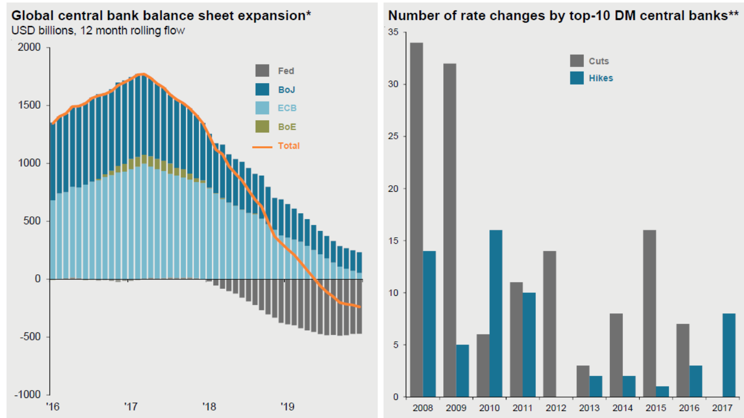
The Federal Reserve and other central banks are reacting to an economy that appears able to support itself by beginning the process of drawing stimulus out of the system. In addition to beginning a rate tightening cycle, the Fed also commenced the run off of its balance sheet, the final step in reversing the quantitative easing policy. It is expected that the U.S. will lead this unwinding and other central banks will gradually follow over the coming years. As the graph below shows, global central banks are likely to move from being net buyers of assets to net sellers in the next few years.



Source: J.P. Morgan Asset Management; (Left) Bank of England, Bank of Japan, European Central Bank, FactSet, Federal Reserve System, J.P. Morgan Global Economic Research; (Right) Bloomberg. *Includes the Bank of Japan (BoJ), Bank of England (BoE), European Central Bank (ECB) and Federal Reserve. Balance sheet expansion assumes no more quantitative easing (QE) from BoE; tapering of ECB QE to 30bn EUR in January 2018 and 0 in October 2018; tapering of BoJ QE to 50trn JPY ann. in 1Q18, 40trn JPY ann. in 2Q18, 30trn JPY ann. in 4Q18, and 20trn JPY ann. in 2019; and tapering of Fed QE per the September FOMC statement, incorporating a maturity schedule. **Including: U.S., Eurozone, Japan, UK, Canada, Australia, Sweden, Norway, Denmark and Switzerland.
Guide to the Markets – U.S. Data are as of December 31, 2017.

J.P.Morgan
Asset Management

This shift is significant, and important to monitor, because the support of the central banks has been a key factor in both rising asset prices and market stability. The impact of this shift could be significant on a few fronts. It is likely that there will be upward pressure on interest rates. Combined with this upward move in rates, there is also a shift in market dynamics that could have a broader impact. For many years the U.S. has run budget deficits but a large portion of the deficits have been funded by the Federal Reserve buying assets. Now those deficits are even larger and must be financed by the market with central bank demand declining. The good news is that none of this exists in a vacuum and we are confident that central bankers are willing and able to adjust policy as conditions evolve.

A last potential for change could come from the political system as we approach the midterm elections this fall. Historically, midterm elections are negative for the incumbent party. This could impact the markets which have responded positively to the increase in business friendly policies of the new administration. A shift in political power could cause concern that a less business friendly environment is on the way. This could negatively impact business confidence which ultimately could have an economic impact.

Be careful what you wish for:

For years market participants have bemoaned slow economic growth and low interest rates. Investors and central bankers were actually much more concerned about deflation than inflation. Now we have a period where growth has accelerated and brought with it higher interest rates and signs of inflation. Though this is the exact objective of the policies that have been pursued, there is now more concern as they seem to have worked.

Investors are currently concerned about the pace at which interest rates have begun to rise. It seems that the tax cut has essentially thrown gasoline on an already healthy economy. This jump in economic activity, perhaps combined with concern over an increasing lack of fiscal discipline in the U.S., has led bond investors to demand higher returns thus pushing interest rates up rather quickly. Similarly, this accelerated growth along with a very tight labor market has sparked long dormant fears of inflation.

Combine these changes with the idea that many investors have not considered inflation and interest rates in many years and you get a level of panic in the markets. Add to this picture a new relatively unknown and untested chair of the Federal Reserve and a lack of confidence in our political leaders and you get a suddenly volatile market. It is important to understand these concerns and attempt to place them in context.

Back to the future:

We have to look beyond the recent past back to more economically normal periods to get a feel for what the future might hold. The last several years have been such an anomalous period that many investors have forgotten, or never experienced, a market previously considered normal. The era of central bank intervention that followed the financial crisis has left investors unfamiliar with the challenges we are beginning to face.

We would consider current market conditions to be quite favorable, particularly after the most recent sell-off, in comparison with a historically normal market. The S&P 500 is currently at a valuation level of approximately 17 times expected earnings. This leaves the market just slightly above its long-term average and actually lower than it was a year ago. Considering current interest rates and inflation, this level is very consistent with historical norms.

Inflation and interest rates are at historically very low levels even after the recent rate increases. While there is some merit to the concern about how quickly rates have moved, it is hard to find the levels alarming and there is a logical explanation.

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"Back to the Future"

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The plausible return of a more normal business cycle has surprised both the markets and investors. Spurred on by a rise in corporate optimism and deregulation, the economy began to accelerate following the election. The tax cut likely only increased this momentum creating what may be the first period of sustainable economic growth since the financial crisis.

Through this lens, the move in interest rates and related concerns about inflation seem to be consistent with what would be expected. It is normal for interest rates and inflation to rise as economic activity increases. On one level, it is surprising that it has taken this long for interest rates and inflation expectations to respond.

Admittedly, it is too early to call the current environment normal given we are still dealing with a degree of uncertainty regarding the Federal Reserve's unwinding of its extraordinary monetary policy actions. Additionally the U.S. debt level and apparent lack of fiscal discipline, while less unprecedented, are similarly concerning. Add to these concerns a list of geopolitical hot spots that is a little longer than average and you can certainly understand why investors are worried.

Recently I have found myself thinking back to the early days of my career when a similarly green colleague and I were trying to understand the market during a period of extended volatility. We found ourselves asking each other almost daily, "*Are we rooting for good news or bad news today?*" Good news meant a stronger economy but, also concerns of a more aggressive Federal Reserve. Bad news meant more Fed stimulus. Such is the common theme of an economic transition, but in the long run good news is usually good news. It does seem that many of the problems of the market today are, in fact, the byproducts of good news. Any of these issues can become bad news in the long run. However, from a short to intermediate time frame the challenges of today appear to be modest and manageable from a historical perspective.

We will continue to monitor economic and market conditions through the lens of historical perspective and current market, political and economic influences. We encourage and value your questions and input. If the recent volatility has raised your concern about your investments or your financial plan, we want to know and schedule a time for a review.

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