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INVESTMENT MANAGERS

ECONOMIC UPDATE March 2018

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After 10 consecutive months of gains, the stock market recorded a loss for February. Volatility returned during the month after remaining historically low for over a year. After falling more than 10% earlier in the month the S&P 500 posted a loss in February of -3.7% for the month. The small cap stocks in the Russell 2000 index were down slightly more with a -3.9% loss for the month. International stocks in the MSCI EAFE index also gave up some of their recent gains, recording a -4.5% loss. Emerging markets stocks followed suit with a -4.6% loss for February. Yields on the ten-year US Treasury continued their recent climb finishing the month at 2.87%. Because of the increase in yields, bond prices fell resulting in a -0.9% loss for the Barclays Aggregate Bond Index.

The estimate for fourth quarter GDP growth was revised to an annual rate of 2.5%. The advanced estimate had been 2.6%. This revision is primarily due to an increase in the PCE price index from 2.7% to 2.8%. For the full year of 2017, real GDP increased 2.3% compared to an increase of only 1.5% in 2016. This is a solid improvement in the rate of growth of the US economy with further improvements expected in 2018.

The 4th quarter corporate earnings season continues to show very favorable results. With 470 out of 500 companies in the S&P 500 reporting, results are up 14% from the same period last year and revenues are up 8.5%. Estimates for Q1 2018 are also going up meaningfully, in part due to the tax law changes that go into effect in 2018. After-tax corporate profits will likely show a very positive increase in 2018 due to the combination of stronger economic growth and lower corporate tax rates.

Paradoxically, the good news is part of the reason for the stock market correction in February. The stock market is a forward-looking mechanism and the good news leads investors to think about the likely action the Fed will take in response to economic conditions. Since the Fed has a dual mandate to keep price levels stable and encourage full employment, the normal response to strong economic conditions and low unemployment is to raise interest rates. By doing so they can contain the rate of economic growth to prevent high inflation.

If Fed policy worked perfectly ever time, we would have economic growth between 3%-3.5% and inflation of about 2% all the time. However, our economy is far more complex than that and we tend to move in economic cycles. Investors worry that the Fed will overreact and put our economy into recession. The market expects 3 to 4 rate increases of 0.25% each this year which would put the Fed Funds rate between 2.25% and 2.5% by year-end. If US Treasury bonds respond in-kind we would likely see the 10-year US Treasury yield around 3.25% to 3.5% by year-end as long as economic conditions remain strong.

Although higher yields can be a headwind to rising stock prices, JPMorgan believes there is still room for stock prices to grow even as yields rise at least until the 10-year Treasury yield reaches 3.5%. Most analysts expect stocks to outperform bonds again in 2018 as rising rates may result in flat to negative returns for bonds. Many also expect stock volatility to pick up again. We continue to believe a diversified approach to investing is prudent. If you have any questions, please do not hesitate to contact us.

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