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Volatility Returns and Markets Reset

Strong corporate earnings in the fourth quarter of 2017 and a much larger than expected U.S. fiscal stimulus bill, passed early in the first quarter of 2018, provided an initial boost to the stock market in January of 2018, but the positive market movement was undone by interest rate increases and a spike in average hourly earnings, which triggered an inflation scare. In the first quarter of 2018, the yield on the U.S. 10-year Treasury note ended the quarter at 2.79% and the 30-year bond closed at 3.02% yield. In addition to four expected interest rate increases in 2018, the Federal Reserve is running down its balance sheet at an accelerating pace this year, which is worth about one additional rate hike. In February of 2018, the equity markets began violent intraday trading swings presenting equity investors with new worries. The recent volatility left the S&P 500 Index with two straight monthly losses and a negative total return of -0.76% for the first quarter of 2018. The Russell 1000 Index declined -0.69% for the same period on a total return basis. Concerns about tariffs, trade wars, rising interest rates, inflation, and equity valuations have overshadowed good news like higher corporate earnings and strong economic growth. The MSCI EAFE Index (USD Net) and the MSCI World Index (USD Net) were also under pressure, with declines of -1.53% and -2.18% for the quarter. The global markets again appear to be susceptible to contagion from company specific news.

Globally, central banks are gradually and systematically withdrawing their unconventional measure of monetary stimulus that has supported the market rally since 2009. The prospect of further interest rate increases has impacted volatility, particularly in the Technology and Financial Sectors.[1] U.S. M2 growth has slowed substantially as the Federal Reserve has tightened. Because the velocity of money is continuing to fall, inflation is not returning if more money cannot change hands. LIBOR is up partly due to new Treasury issuance post debt ceiling. The rising debt of global governments appears to be part of the problem for slowing world growth at a time when growth is accelerating from pent-up demand. The additional economic output or GDP generated by each additional dollar of business debt in the U.S. has been falling. China, which has doubled its debt since 2009, has also seen its return on debt diminish. Over the last half-century, higher government bond yields and deficits have been associated with recessions.[2] Additionally, the market reset is amplified by crowded trades in technology and credit, product proliferation of ETFs, and over-leveraged investors. The XLK ETF, which consists of the S&P 500 Index technology companies, and the XLF ETF, which consists of the S&P 500 Index financial companies,

demonstrate a similar bias of overtaking other economic sectors as a percentage in the S&P 500 Index.[3] The current synchronized pickup in global growth is also increasing volatility as new leaders arise and fiscal policies become accommodative.[4] In fact, a fiscal stimulus in the U.S. at the time of full employment may encourage more market volatility as debt is increased and policies become stimulative.

"Many investors have been unwilling to embrace the equity bull market since 2009 and those invested now believe the bull market is about to end" said Joe Zidle of the Blackstone Group, LP.[5] The 2009 to 2018 bull market, from beginning to peak, averaged 17.3% annually. Nominal GDP rose 3.6% annually during this time, and real GDP rose 2.1%. In the 1982 to 1990 bull market, the equity market rose 17.5% annually, but nominal GDP rose 7.6% and real GDP rose 4.2%. The winners of this bull market have mainly resided in a few names, specifically, the FANG stocks: Facebook, Amazon, Netflix, and Alphabet (formerly Google). These companies exploited how to connect people via technology.[6] Not only were only a few companies responsible for the huge market gains, but the number of investors choosing to invest in the equity markets was small compared to other asset classes. According to Morningstar Inc., U.S. Equity exchange-traded funds (ETFs) and equity mutual funds have taken in $281 billion over the past decade, while at the same time international stock funds attracted more than $1 trillion and corporate bond funds drew almost $2 trillion.[7] After a nine-year equity bull run with market volatility effectively repressed, we believe the focus of equity investors is now changing to fundamental factors such as price to earnings ratios, the gap between short and long-term bond yields, tightening credit conditions, consumer confidence, and the gap between short and long-term interest rates. At this point, approximately 68% of these indicators are worrisome, suggesting there is more time before the stock market peaks, which typically occurs when 80% of these indicators rise. The present period does not suggest that a bear market has begun, and equity returns in the final stages of a bull market can be very strong.

The midterm election year of 2018 is following a typical pattern for midterm election years, which tend to have larger equity market corrections than the other three years of the four-year presidential cycle. One of the main reasons for a downturn in midterm election years is that in five of the past six midterm election years, at least one Congressional Chamber changed political parties. The present elected party tries to enact policies, which tend to negatively impact the market, such as the Clinton Impeachment, the Iraq War, the Affordable Care Act, and Dodd-Frank. In 2018, there are possible scares from policies, such as technology regulation, tariffs, trade wars, immigration, and possible impeachment proceedings, that would negatively impact the markets. Historically, midterm election sell-offs tend to be a great buying opportunity with stocks up one year later each time since 1962. Additionally, the S&P 500 Index has not declined in the 12 months following a midterm election year since 1946.[8] While the decline in

value of many of the best performing stocks over the last 12 months may be disquieting, this typically signals that the worst of a correction is finalizing.[9]

Martin Investment Management, LLC believes that markets are eventually efficient, but not in short time periods. The present repricing of financial assets in the marketplace is directly connected to the transitions occurring in monetary, regulatory, trade, and fiscal policies. Systematically important institutions, such as the Federal Reserve, are gradually withdrawing their market support of suppressing volatility. At the same time, fiscal policies are changing with The Tax Cuts and Jobs Act of 2017 and the Bipartisan Budget Act of 2018, which are projected to place the U.S. deficit above $1 trillion by 2019 even as the unemployment rate may move lower. The result is that monetary and fiscal policy are moving in opposite directions, with the Federal Reserve making the debt from the new legislation more expensive with higher interest rates. We believe that investors would be better served by an orderly and efficient unfolding of these transitional changes by policy makers. Unfortunately, world policy makers are often influenced by short-term conclusions. Pro-growth policies, which enable the natural economic healing process to occur, should be preferred over debt, tariffs, and trade wars, which could hinder global growth.

Presently, the global cyclical tailwinds appear stronger than the policy headwinds, but this could shift as the markets respond to the global trade and debt imbalances. As long as global growth can proceed in a sustainable and inclusive way, we believe that the market can transition from one supported by liquidity to one based on stronger economic and corporate fundamentals. We believe there will always be opportunities in the marketplace. At this time, technology may continue to provide growth in related sectors, such as industrial robotics, healthcare genome sequencing, energy extraction and storage, and virtual financial currency. Ultimately, we believe that over the long-term, monitoring market-based variables and analyzing corporate fundamentals offers us the best opportunity to assist our clients in their equity investment portfolios. We are focused on our fundamentally driven, bottom-up investment process for capital appreciation and capital preservation over a full market cycle.

Our wish for a warm and more colorful spring season!

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1. Buttonwood, “More Market Volatility Seems Likely”, *The Economist*, March 28, 2018.
2. Mauldin, John, “Springtime Chart Fling”, *Advisor Perspectives*, March 31, 2018.
3. Mauldin, John, “Springtime Chart Fling”, *Advisor Perspectives*, March 31, 2018.

Note:

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4. El-Erian, Mohamed, "Ten Things Investors Should Know About Market Corrections", *Financial Advisor*, March 21, 2018.
5. Zidle, Joseph, Quoted in "Investors Worry They Stayed Too Long" by Asjylyn Loder, *Wall Street Journal*, March 28, 2018.
6. Mauldin, John, "Squares, FANG, and Stock Valuations", *Advisor Perspectives*, March 23, 2018.
7. Loder, Asjylyn, "Big Trade Rattles Nasdaq Futures Before Open", *Wall Street Journal*, March 28, 2018.
8. Strategas Partners, March 27, 2018.
9. Strategas Partners, March 28, 2018.

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