Why The Recent Volatility?

4-2-18

These last few weeks the stock market has seemed incredibly volatile. We've recently seen weekly market swings in the S&P 500 of approximately +4%, -1%, -6% and +2%. We feel it and by our recent conversations with you, we know you feel it too.

2017 was an abnormally calm year. The ups and downs we've seen in 2018 are closer to a normal market. As we've said on many occasions, volatility is normal and healthy. In an average year, the stock market tends to have at least one correction of 10%+ and multiple drops between 5% and 10%.

What has been causing the recent volatility? Foreign trade concerns, pressure on the disruptive technology stocks, expectations for higher inflation/interest rates, and speculative trading have fueled the increased volatility this year.

We can't know with certainty what the future holds, but bear markets rarely happen without a recession. At this point a recession remains only a remote possibility. The global economy is gaining strength rather than losing it. And, companies continue to raise their earnings expectations.

Foreign Trade

Two weeks ago, President Trump signed an order that called for roughly $15 billion worth of tariffs on Chinese imports to the United States. China immediately retaliated with roughly $3 billion worth of tariffs. Earlier in the year, the US imposed a 10% tariff on imported aluminum and a 25% tariff on imported steel. These tariffs could raise costs for certain companies, but the impact on most companies and the economy as a whole is small. The total impact is roughly $37 billion. While not an insignificant amount, this represents a tiny fraction of our nearly $19 trillion economy.

A bigger concern would be a further escalation of tensions and retaliation from other countries. A full-blown trade war would be bad for the US economy, consumers, corporations, and markets.

This administration's "fair trade" agenda with other countries - especially China - will likely continue. However, the trade war narrative is unlikely to derail the current economic expansion. We still believe this tariff talk is part of the negotiation process aimed more at bringing countries to the table.

Tech Stocks

Facebook has come under fire for its mishandling of user data. Allegedly, Facebook data obtained without user permission was used to target ads during the 2016 presidential election. These allegations were enough for the Federal Trade Commission to launch a formal investigation into the company's privacy practices.

Investors are concerned that the "FANG" stocks (Facebook, Amazon, Netflix, and Google) may find themselves under increased regulatory scrutiny. These companies collect an abundance of sensitive user data. When mishandled, the repercussions can be large.

The "FANG" stocks are large weightings in a number of passive index funds. If sentiment turns away from these stocks, this could have a spillover effect on the rest of the market.

Inflation, Interest Rates, and Speculators

While foreign trade has been the main culprit of market volatility, expectations for higher inflation and interest rates have weighed on market as well. Better than expected wage growth in January sparked concerns that inflation could be returning faster than expected. Higher inflation could lead the Fed to increase short term interest rates faster than anticipated.

When volatility rises, speculative traders using automated trading programs can amplify movements in the market. When stocks fall to certain levels, they often trip the algorithms to sell automatically. These short term traders pay little attention to underlying economic data or company fundamentals. Many of these day to day movements in stocks are nothing more than noise, but they can impact your portfolio in the short-term.

What does this mean for your portfolio?

Our view on stocks has not changed at this time. We don't turn a blind eye to these events, but we continue to focus our attention on what ultimately drives stock prices: growth in the underlying business fundamentals.

Regardless of what happens day to day, stock prices have historically followed earnings and dividends. Both are expected to grow rapidly over the next few years. Earnings for the S&P 500 are expected to grow by over 18% this year and over 10% in 2019. These estimates are being amplified by lower corporate taxes and an improving global economy.

It has been easy to make money simply by owning passive index funds over the past few years. This may be changing with the "FANG" stocks coming under pressure of late. Our focus remains on companies that are consistently increasing their fundamental values by growing their earnings and dividends. In the long term, improving fundamentals will prevail.

Steps have already been taken in client portfolios to prepare for our current market environment. If trade pressures pick up, reducing exposure to companies with a large share of their business outside the US would be a logical solution to counter the pressure.

Periods of market volatility are not fun to go through, but know that you don't walk through them alone. We are always here to walk through these rough spots with you. Don't hesitate to call your Portfolio Manager with questions, concerns or comments.

Blessings,

Your Investment Policy Committee