US Private Wealth Management
U.S. Bank

An increasing degree of difficulty

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The recent Winter Olympics provided a brilliant display of athletic ability and artistry. Some of the newer Olympic events included aerial acrobatics, where athletes are launched into the sky via a snowboard or skis, performing tricks and attempting to “stick” landings, not unlike fellow athletes, such as gymnasts or figure skaters. Some of these events determine the medalists based on an athlete’s best score relative to their competitors, with each competitor granted a set number of attempts or rounds. As the scores aggregate and the rounds reach their climactic end, the skills required to reach the podium increase and as the degrees of difficulty rise, so do the risks.

The degree of difficulty has similarly risen in financial assets in recent weeks. While some claim this is because the current rally in risk assets has gone on for a long time, we don’t think that is the real story. To be sure, this month marks the ninth year since global equities bottomed following the greater than 50 percent decline experienced during the great recession. However, while the domestic economic recovery has been long (and equity markets have reflected improving corporate profits), it has also been the shallowest recovery from a recession in post-World War II history. Obviously, looking at time alone does not tell the full story.

We see three reasons why the degree of difficulty has gone up.

- First, central banks are moving away from pro-growth policies towards slowing liquidity to actually draining it. The U.S. Federal Reserve, followed by the European Central Bank and also, as of this morning, the Bank of Japan are all either actively removing stimulus from their economies or at least framing how they will do it in the future. Central banks have been active market participants for over ten years so their transition to new plans shape markets. We estimate that the major global central banks (United States, China, Japan and Europe) have amassed over $20.1 trillion in assets. There is no historical precedent for unwinding those assets, no matter how gradual.

- Second, concerns about inflation have entered into the market’s psyche. Upward price pressures have been eerily absent during the global economic updraft. However, recent wage and producer goods data suggest prices may not remain dormant. Given the synchronized global growth environment, with several major economies growing at the same time, central banks that are already in liquidity draining mode may accelerate their time table, moving faster than markets expect. In the United States, the tax cuts and recent spending bill passage leave many concerned about the looming deficit and whether a buyer of U.S. government bonds may want higher compensation than what bonds currently offer. With interest rates close to all-time lows on a global basis, markets are particularly sensitive to inflation surprises here.

- Third and finally, geopolitical relationships may provide challenges. Some argue that the 19th National Congress of the Communist Party of China in October 2017 signaled a more inward-focused Chinese agenda, and that the current U.S. administration’s tariff intentions announced earlier this week could lead to market concerns about future trade policy. Corporations that rely on both stable trade relations and currencies could be adversely impacted by back-and-forth between major trading partners.

Through early February 2018, U.S. stocks, as represented by the S&P 500, enjoyed their longest run without a 5 percent decline, a streak totaling 404 consecutive trading days.* Since that streak ended, the capital market backdrop has shifted from a placid, low volatility environment to one with decidedly more chop. While domestic equity markets have averaged a 13 percent intra-year decline over the past 20 years (and their international counterparts have averaged even more),* recent downward moves following a tranquil period have felt more pronounced. As of market close on Friday, March 2, U.S. stocks are 6 percent off of their all-time highs reached in late January of this year — but it "feels" deeper than 6 percent.

In our view, the issues outlined above are not insurmountable and policymakers and market participants may be able to "stick the landing" despite these and other cross currents. We have described the glass as being half full with respect to the forward risk/return picture. We have recently dialed back that assessment to being more balanced than we concluded in prior quarters. The global economic momentum remains impressive, but markets have already discounted a lot of that good news, with several asset classes at higher valuation levels. While we think economic growth has some longevity left, we want to let our clients know that we are focused on some of the accompanying risks that could impact markets.

As always, we value your trust and are here to help in any way we can. Please do not hesitate to contact your Private Wealth Advisor for insights related to your unique circumstances or if we can be of assistance.

*Data source: Bloomberg

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