A look back and a look forward
An important investment market update from: Eric J. Freedman, Chief Investment Officer, U.S. Bank Wealth Management
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The week in review
The current capital market environment has migrated from placidity to volatility in abrupt fashion. Ten trading days since U.S. equities (as measured by the S&P 500 Index) hit their all-time highs, stocks quickly shed nearly 12 percent from those levels at their lowest point intraday on Friday, February 9. This recent market movement was triggered two weeks ago by inflationary concerns — ironically after nearly ten years of the global economy underperforming its long-term potential, some recent readings indicated growth may be too good. Economic data released last week showed wages were increasing more than expected. Shouldn’t it be a good thing for people to have more money to spend on such things as clothes, dining out and vacations?

In our view, the answer to that question, like most things in the economy, is “it depends.” When I was in graduate school, my macroeconomic professor (who was also a Federal Reserve economist) advised us that if we were ever stuck on an essay response in his class, starting an answer with “it depends” would garner at least partial credit. Normally, rising wages, increased corporate spending, lower tax rates and other stimulative measures are boosts to the economy. However, the impact of these things on an economy and on your portfolio’s asset class returns “depend” on other factors.

Right now, prevailing global growth rates and interest rates are the two most important factors shaping the effects of these stimulative variables. For the first time in a long time, countries and regions appear to be growing in a synchronized fashion, following very disparate recovery patterns post the Great Recession. That growth is also occurring during a time of historically low interest rates across the globe — before the most recent volatility spat, interest rates were low in the United States, Japan, Europe and other major countries and regions. Central banks attempt to regulate economic velocity via setting interest rate targets. Prior to the more recent uniform global growth readings, interest rate targets had been very low, with central banks encouraging more borrowing and spending, following a veritable freeze in credit availability. Low interest rate targets meant lower mortgage payments for consumers and a lower cost of debt issuance for many companies.

Lower corporate and consumer tax rates in the United States could spur near-term spending and also further strengthen economic activity. Markets are concerned that central bank policy could become restrictive in response, raising borrowing costs as central banks raise interest rate targets in an attempt to temper economic activity so price levels don’t increase too far, too fast. Additionally, concerns about U.S. deficit levels increasing, following the most recent spending bill and tax changes, may cause bond holders to demand higher compensation for lending. This may impact corporations accustomed to several years of easy money. This logic was at least partially responsible for the initial move higher in bond yields last week, which, of course, move in the opposite direction of bond prices.
The other factor that has driven gyrations over the past week has been the impact that price movements have had on certain investor types due to adverse portfolio positioning. Money managers who take views on the future direction of volatility, or price movements across markets, were caught offside last week. Thanks to very calm markets for years, especially domestic equity markets (the S&P 500), which had not had a 5 percent decline in over 400 days prior to last week, many managers had positions that would benefit from continued calm. That calm was disrupted and those managers were forced out of losing positions thanks to margin calls. The knock-on effect of this selling extended from government bond markets to stocks and more recently into foreign exchange, energy and corporate bond markets. The contagion picked up speed as the week carried on, with some relief on Friday (February 9) following steep intraday declines into the early afternoon that quickly reversed.

A look ahead
While stocks had a meaningful recovery from Friday’s nadir, we expect that volatility will likely continue in the coming weeks across asset classes as markets digest the potential for higher interest rates, and as investors who may have caught offside by the rapidly rising volatility square their portfolios. One of the reasons we are still near-term cautious is because even though U.S. stocks turned sharply higher on Friday, corporate credit, and especially high yield credit, was very weak and did not enjoy the same updraft. The same can be said for many energy markets. Also, government bond yields also climbed sharply higher (prices fell), and it will be hard for stocks and other asset classes to sustain moves higher unless bond yields settle or even head lower in a gradual fashion. Thus, the reconciliation process of higher interest rates and adverse portfolio positioning could take some time, meaning weeks or even months. We hope this will not be the case and that the reconciliation may be swifter, which could result in strong performance days like today for risk assets. However, hope is not an investment strategy.

We have expressed a “glass half full” portfolio mantra over the past 18 months, which has served our clients well. We remain positive on economic fundamentals and corporate profits. They appear durable and broad based. Prices have already fallen to reflect increased future concerns that may or may not prove prescient and warranted. With a time horizon that extends to years, we remain positive on the path for forward returns. In the very near term, we retain that “glass half full” view and will certainly alert you should our views change. Investment maxims, like rebalancing, diversification and recognizing your time horizon, are critical in all periods and this one is no different.

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 if we can be of assistance.
client goals, objectives and tolerance for risk. Not all recommended asset classes will be suitable for every portfolio. Diversification and asset allocation do not guarantee returns or protect against losses.

**Past performance is no guarantee of future results.** All performance data, while deemed obtained from reliable sources, are not guaranteed for accuracy. Indexes mentioned are unmanaged and are not available for direct investment. The **S&P 500 Index** consists of 500 widely traded stocks that are considered to represent the performance of the U.S. stock market in general.

**Equity securities** are subject to stock market fluctuations that occur in response to economic and business developments. **International investing** involves special risks, including foreign taxation, currency risks, risks associated with possible difference in financial standards and other risks associated with future political and economic developments. Investing in **emerging markets** may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in **fixed income securities** are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Investment in debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities.