ACCESS | WEALTH MANAGEMENT

April 11, 2018

Key Points

- Stock markets have behaved much differently in the last two months as compared to the previous year. Increased volatility, however, doesn't mean the end of the bull market, but it is becoming a more challenging environment.
- The U.S. economy shows few signs of slowing down but risks to growth are rising as trade issues emerge and the Federal Reserve continues its tightening campaign.
- The global wall of worry has a few more bricks in it, but positive news should help markets continue to climb that wall, although trade protectionism remains a threat to global growth.

A Changing environment

The market that let negative news just roll off its back is now showing much more sensitivity to ongoing political turmoil, White House personnel shakeups, tariff announcements, data breaches, etc. As we've noted in the past, last year was the exception; this year is closer to the norm. But, ironically, this is probably a healthier investing environment which could actually help keep the bull market alive. Let me explain. Valuations, which were quite extended as we entered 2018 have had the chance to retreat somewhat—courtesy of both the correction in prices, but also the strength in earnings. Additionally, sentiment conditions as measured by the NDR Crowd Sentiment Poll had gotten to record optimistic levels but have now corrected back to the neutral level. Both of these developments are worth cheering, but unlikely to keep continued volatility at bay (with some "bunny"-like tendencies likely—more on that later).

Risks are rising

Stocks dropped after President Donald Trump instructed the U.S. Trade Representative to find an additional $100 billion of Chinese goods on which to place 25% tariffs, another step in a weeks-long dispute over trade. The announcement was viewed as raising the potential for a trade war. Separately, the March labor report from the Bureau of Labor Statistics showed weaker-than-expected payroll growth, an unchanged unemployment rate and slightly higher wage growth.

Schwab's Chief Global Investment Strategist Jeffrey Kleintop says the war of words may amount to little more than that. "Though trade wars were once common, we haven't seen one in 90 years for lots of good reasons that remain in place today," Jeffrey says. A few of those reasons include:

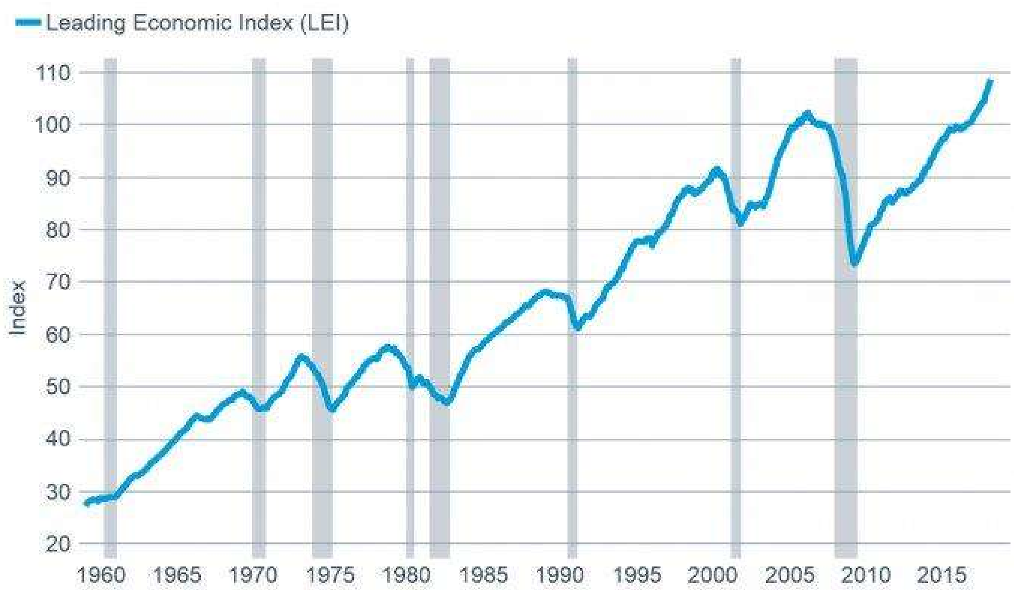
- The legacy of economic destruction they caused in the 19th century
- Increasing globalization
- Longer supply chains
- The World Trade Organization (WTO) dispute resolution process.

It's not just the United States which is suddenly dealing with increased concerns. Stock markets around the world have reacted negatively to the risk of a trade war—global companies making up the MSCI World Index earn more than half of their sales from international trade. The result has been that tariff changes in recent decades have been modest, narrowly-focused, and short-lived. We hope this one is no different. However, the U.S.-China trade negotiations and announcements over the coming weeks may persist in causing volatility disruptions.

"Protectionism broadly, and tariffs specifically, have historically boosted inflation while causing economic growth to slow, which could make policy setting by the Federal Reserve more difficult, and lead to ongoing bouts of market weakness and heightened volatility," says Schwab Chief Investment Strategist Liz Ann Sonders. "The economy still looks healthy and we believe the upcoming earnings season will be solid, but the expectations bar is now set high, setting up the possibility of underperforming those loftier expectations."

Corrections are always unnerving, especially because they tend to be processes over time as opposed to condensed moments in time. The U.S. economy doesn't look to be anywhere near a recession, which have historically accompanied bear markets. The Index of Leading Economic Indicators rose again in March, continuing a robust uptrend.

LEI indicates no near-term recession



Source: Charles Schwab, Macrobond, Conference Board as of 3/27/2018

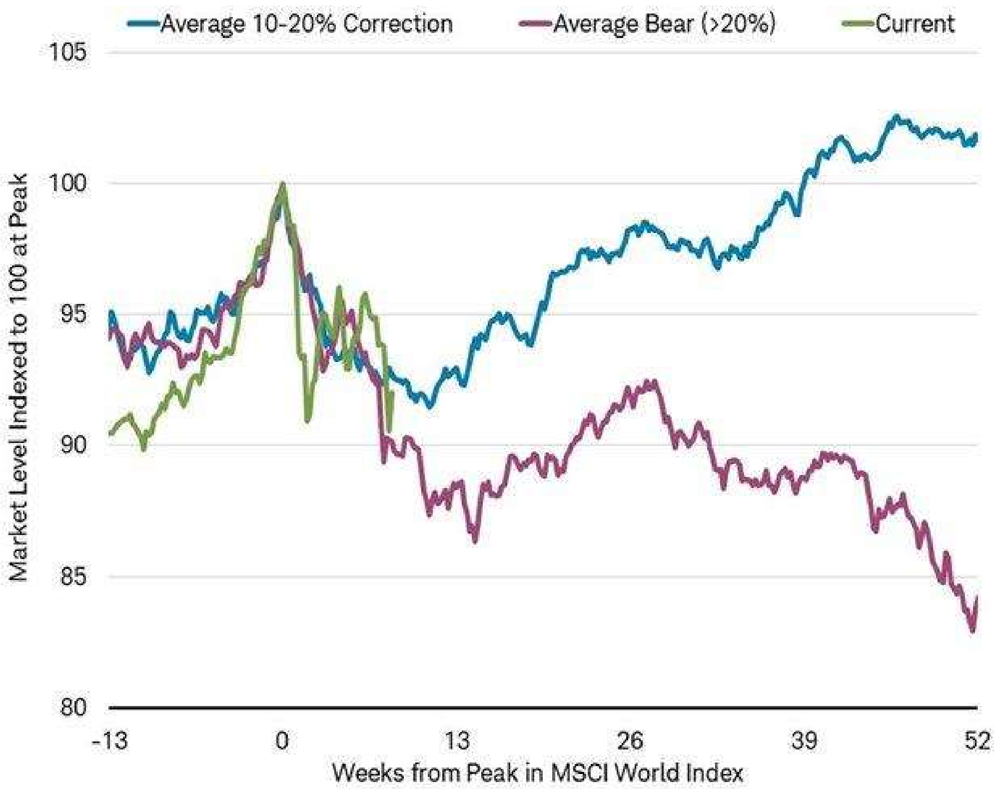
Don't forget Washington—the positive side that is

It's easy to focus on the negatives coming out of Washington, and for good reason, but at times we can lose sight of the positives. The U.S. economy should have a tailwind that is just beginning due to the tax cuts that the majority of Americans are just now incorporating into their budgets. Additionally, we can put worries of another government shutdown to bed, as a new spending bill passed, which should add to near-term economic growth. Down the street, the Federal Reserve continues to tighten policy, while the new Fed Chair Jerome Powell handled his first press conference with ease. The Federal Open Market Committee (FOMC) indicated a continued steady pace of hikes alongside an upward move in its summary of economic projections—all of which should be beneficial in the near term to stock markets. Caveat: the timing of fiscal stimulus—coming much later in the cycle than is typically the case—does elevate the risk that inflation heats up, which could push the FOMC to tighten more quickly.

Global "Bunny" Markets?

It certainly doesn't "feel" like a bull market right now—it's more of a "bunny market," as the jittery stock market hops up and down. But that behavior isn't unusual after a pullback. In fact, based solely on prices, it's too soon to tell if this is a cyclical/non-recession bear market or just a bull market correction. In either case, stocks tend to bounce around before re-establishing a trend, as you can see in the chart below of past bear markets and corrections in the MSCI World Index since 1979.

Too soon to tell?



Source: Charles Schwab. Bloomberg data as of 3/27/2018. Past performance is no indication of future results.

Of course, trade fears are not the only reason global stocks have been weak. If the concerns were just trade-related, it is likely that emerging market stocks would be underperforming developed market stocks, given their heightened sensitivity to trade growth. However, since the market peak on January 26 of this year, the MSCI Emerging Market Index has actually fared a little better than the basket of developed market companies that make up the MSCI USA and MSCI EAFE (Europe-Asia-Far East) Indexes.

So what?

Sharp moves and stocks continuing to flirt with correction territory have been the hallmarks of the market lately. While unnerving at times, we continue to stress the importance of patience and sticking to your long-term plan. We expect to see continued elevated risks, and more "bunny-like" behavior in the near term. As Greg Johnson, a portfolio manager for the American Funds Group said, "In my view the U.S. is priced for perfection, so I am taking a more cautious approach, gravitating to areas that I believe can hold up better in choppier markets." In the long run, cheaper (more attractive) valuations lead to some nice buying opportunities for patient investors. And as Warren Buffet said, "The stock market is a device for transferring money from the inpatient to the patient." It is time for balance, flexibility and a focus on long-term success – and that is exactly how we have our clients positioned.

Respectfully,

Anthony L. Christensen, CPWA®
President, Managing Partner

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