Market & Economic Commentary: Your Captain Has Turned On The "Fasten Seatbelt" Sign.

Winter 2017/2018

Jim Scheinberg CIMA® AIFA ®
Managing Partner
jim.scheinberg@npier.com

(800) 403-7065
www.npier.com
www.northpiersearch.com

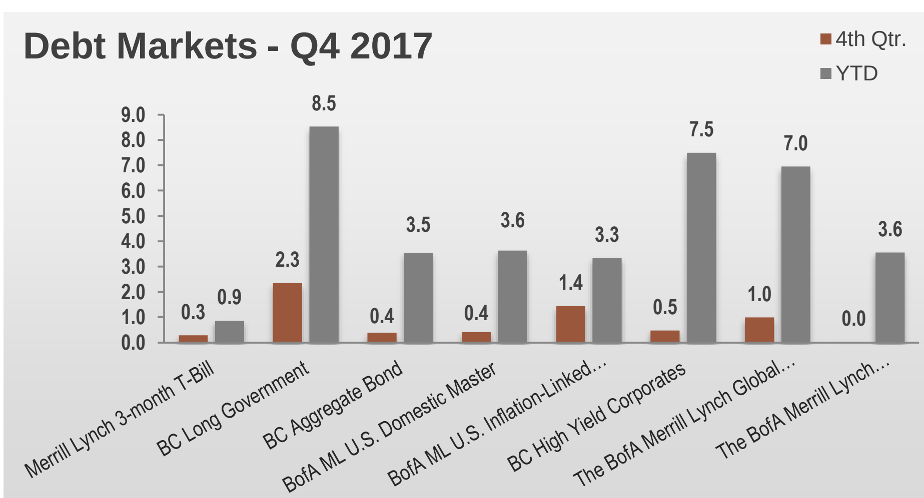
<u>Your Captain Has Turned On The "Fasten Seatbelt" Sign.</u>

Clearly the smooth ride in the equity markets of the last 14 months has been disrupted by some un-telegraphed turbulence. Though the dust has not fully settled, it appears that early February's 10% correction in the S&P500 was caused mostly by derivatives trading based on bets on the movement of the VIX – the S&P 500 Volatility Index. Ironic, isn't it? The thing that created the volatility, was speculation on volatility itself. It all began when the U.S. markets dropped more than two percent on Friday 2/2 following a series of inflationary statistics being released (unit labor costs and a rise in hourly earnings). This drove interest rates higher due to growing inflation fears, which fueled a speculative selloff in the equity markets. With that Friday's rapid decline, the VIX rose to a post Trump-election high. By Monday, hedge funds and other volatility speculators were facing margin calls and thus the fire began to fan its own flames. The end result was a 10% correction from the January 26th highs, that managed to find a bottom off of the 200-day moving average for the S&P 500 (considered to be a major technical support) on Friday 2/9.

But was there another 'there' there? There appears not to be. All of our monitored pillars of domestic and global economic strength appear to be on solid ground. As we have reported for over two years now, business and consumer sentiment and activity in the United States is strong and either stable or accelerating. Estimates for U.S. GDP growth are now approaching 3%, which we maintain may still prove to be conservative. Further, North Pier's forecasts last year of a strengthening European continent have come true; and global economic growth appears be even more promising as we look ahead to 2018. As such, the euphoric advance of global equity markets that preceded our recent correction may prove to be well founded.

How the Markets Fared

2017 saw a steady rise in stock prices with never more than a 3% decline from ever increasing new highs. This lack of gyration in the markets was unprecedented, and as mentioned earlier, created a boom in financial products to bet on or against a continuation in the trend. The final quarter of the year was simply a continuation of the first nine months. The S&P 500 gained another 6.6% to finish the year up over 21%. Value sectors continued to lag growth sectors, but by a smaller amount. Nonetheless, growth indices beat out value indices by nearly 17% for the year, a complete reversal of 2016's trend. Small caps trailed larger names by a fair margin during the quarter and the year, but still managed to post strong double digit gains. It was investment in international markets that was the real success story for 2017. Developed markets saw gains in U.S. dollar terms of nearly 25%. Similar to the U.S., growth oriented industries dominated more cyclically sensitive areas. Emerging market equities performed even stronger than any of the developed markets, with Asian EM shares surging 43%! Some of these international gains were magnified when viewed in dollar-terms due to a decline in the U.S. dollar, which slide nearly 10% on the year.



Similar to equities, bond rates saw remarkably little volatility during 2017. The yield on the bellwether 10-year Treasury was virtually unchanged, finishing the year at 2.4%. The 10-Year yield never rose higher than about 2.6% and never declined below 2%. This stability on the long-end of the yield curve was unexpected as the Fed tightened interest rates 3 times during the year, leaving Fed Funds at 1.5% to close out 2017. This led to high quality bonds earning little more than their coupons for the year. There was literally no downside volatility to be found in the broader capital markets last year. International bonds did a bit better, again, aided by declines in the U.S. dollar. The only place that really saw gains in fixed income 2017 was a continuation of 2016's hot high yield market. Junk bonds, as they are often called, returned an average of 7.5% to investors during the year, but stalled out in the fourth quarter. Many fixed income pundits have suggested that we are very late in the credit cycle and that the small addition one receives in interest over high quality paper may not be worth the risk. At North Pier we agree that the risk-powder-keg may very well be packed, but we don't see any economic sparks in sight. The economy will need to begin to falter in order for credit sensitive areas of the fixed income market to see any meaningful losses.

[See full commentary for positive reports on business activity, employment and wage data, domestic real estate, consumer confidence and a potential upside in GDP. We also review inflation and upcoming changes at the FMOC.]

PIER*ing* Ahead

Clearly the events of the recent week have shaken markets. We assert, however, that they may simply have shaken investors awake. The advance of 2017 was almost as hypnotic as the drone of an airplane engine. Then flying through the sky at over 500 MPH, many travelers (like me) are lulled into doziness or sleep due to the steady rumble. It only takes a quick jolt of turbulence to wake you up though. Well, U.S. investors are certainly wide-eyed and bushy-tailed after our 10% drop. Now the sober assessment of valuations and relative attractiveness can begin. With economically sensitive value stocks lagging as substantially as they did last year, and expectations for global growth mounting, perhaps it's time for The Street to start paying attention to earning and revenue growth potential *in relation* to valuations, instead of just simply adding another $1000 to the price of Amazon. With all of our economic gages in attractive ranges, North Pier continues to be optimistic on the global economy for the foreseeable future. If our expectations hold true, then earnings will catch up with valuations and the global bull market will continue on. But like any good bull-ride, there are bound to be some bucks and horns along the way.