SPECIAL UPDATE

Brush Fire or Forest Fire?

Thoughts on recent market volatility, February 2018

For the first time in 2 years, the equity market is experiencing a selloff at nearly -5%. For many investors this sparks concerns about the potential that the nearly 9-year-old bull market may be ending. Additionally, bonds are normally a safe haven during equity market selloffs but on this occasion, bonds are also under pressure and are now down for the year. A recap of last week has the Dow down -4.1% and S&P 500 down -3.9%, while the 10-year U.S. treasury wasalso down -1.4%.

A few things to consider before determining if this is a brushfire that cleans out weeds, or a forest fire that burns an entire forest:

- Market corrections of 5% are very normal and usually occur 3 times per year on average.
- Current economic data is good and expected to improve. For example, companies within the S&P 500 are exhibiting earnings growth of 14.81% for Q4 2017 with 256 companies reporting so far and 4th quarter GDP grew at 2.6% and unemployment is down to 4.1%.
- Inflation continues to be 50% below the historical average at 1.8% and interest rates remain near historical lows even though they are up year to date.

The recent selloff in the equity and bond markets can be directly attributed to the longer term potential of interest rates going much higher. The concern is after years of ultra low rates, which allowed for extremely low borrowing costs, companies and individuals will begin to pay more to borrow. This would lead to an inflationary cycle with goods and services increasing in price, which is the first sign of the end of a bull market and start of a recession as the economy becomes over heated.

Our view is that this a normal market selloff, or a brush fire to use our earlier analogy. Current economic data is good and improving. Tax reform will drive earnings higher and justify recent highs, and interest rates will slowly grind higher based on the expanding economy and a conservative federal reserve.

What is unusual about this selloff is both equities and bonds are down at the same time. And while stocks are still up over 3% year to date, as measured by the S&P 500, bonds are down -1.8% as measured by the Barclays U.S. Aggregate Index. Normally when stocks experience positive performance, bonds are flat or down, and vice versa when stocks experience negative performance. Since both are down simultaneously, it leads us to believe this is a temporary situation based on the threat of significantly higher interest rates. However, we do not see this threat materializing since although the economy is expanding, it is not doing so quickly enough to drive rates much higher. ■

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