# It's Windy Out There

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Key Points

- Volatility eased somewhat but the tug of war between positive and negative stock market signals continues. We believe the U.S. equity market remains in a secular bull market, but stocks will remain "windy" and we can't discount the possibility of retesting lows seen earlier this year.

- Political uncertainty is contributing to the volatility, with trade fears and midterm elections on one end, and tax cuts, deregulation, and repatriation on the other. This uncertainty could keep the Federal Reserve more cautious, although gradual rate hikes are likely to continue.

- Military conflict concerns have also risen, but history suggests that unless they become protracted conflicts with economic implications, they have typically had short-lasting impact on markets.

### Winds are picking up

It's been a crazy spring weather-wise for much of the country, and the stock market is dealing with windy conditions as well, making it more difficult for investors to get a clear picture of market direction. Stock market indexes have now had a successful retest of the early-February lows, but selling pressure may not yet be exhausted. In our experience, the average corrective phase historically has brought more duration and still-sharper declines. Geopolitical conflicts, trade worries, debt/deficit concerns, tighter financial conditions, a softer first quarter for the economy, elevated earnings expectations, and midterm elections are some of the things that could push stocks temporarily lower, while a positive resolution to some of these issues could charge up the bulls.

Additionally, investors have expressed concerns about the flattening yield curve; although it's typically only well after an inversion do risks of a recession become heightened. As you can see below, a break below 50 basis points in terms of the difference between the 10-year and 2-year Treasury yields doesn't always lead to recession; and in fact has been historically accompanied by positive equity market performance.

**A flatter yield curve doesn't tend to spell doom for stocks**

| | | | S&P 500 price performance | |
|---|---|---|---|---|
| Yield curve broke below 50bps | Date of inversion | Date of trough | From 50bps to inversion | From 50bps to trough |
| Oct. 1977 | Aug. 1978 | Mar. 1980 | +12% | +11% |
| Aug. 1980 | Sep. 1980 | Dec. 1980 | +3% | +11% |
| Sep. 1988 | Jan. 1989 | Mar. 1989 | +9% | +8% |
| Dec. 1994 | Jun. 1998 | Apr. 2000 | +147% | +216% |
| May 2005 | Jan. 2006 | Nov. 2006 | +7% | +18 |

As of 4/16/18. Bps=basis points. Green circles indicate 50bps cross. Red circles indicate trough of inversion. Source: Bloomberg, FactSet.

As of 4/25/18. Bps=basis points. Source: Bloomberg, FactSet. Past performance does not guarantee future results.

**Temporary reprieves?**

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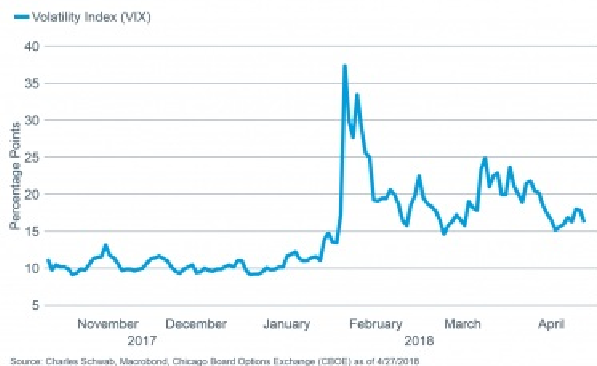
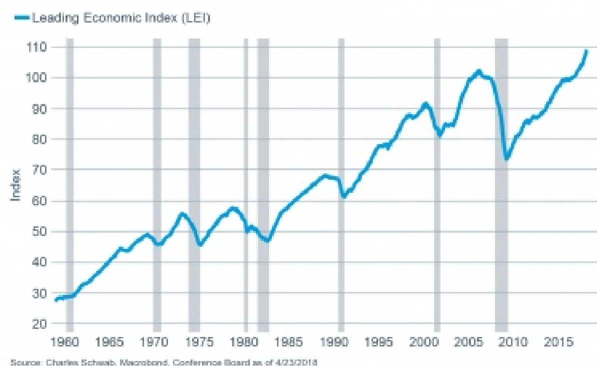



A positive side-effect of three months of volatility is that investor sentiment has moved into the range that is associated with the best annualized gains for stocks, according to the Ned Davis Research Crowd Sentiment Poll.. And there are plenty of tailwinds that can also help to elongate the bull market; with tax cuts for both consumers and businesses coming into effect; a solid corporate earnings picture, with year-over-year growth for the S&P 500 currently expected to surpass 20% this year, according to Thomson Reuters; still relatively low interest rates; and inflation that is tame enough—albeit rising—to keep the Federal Reserve from having to tap the brakes more strongly.

## Economy still supportive

Although first quarter U.S. real gross domestic product (GDP) growth was better than expected but still a bit soft, coming in at a 2.3% annualized, we have discussed many times before the tendency for the first quarter to be softer-than-trend due to myriad seasonal distortions; so we aren't too concerned with that reading, and actually somewhat encouraged that the traditional soft first quarter was better than expected. Other economic data has been strong, in concert with continued strength in the Index of Leading Economic Indicators-- including industrial production, durable goods and housing data.

**LEI signals further growth**




**As does industrial production**

Despite the very strong earnings season so far, stocks have at times struggled, reflecting an elevated expectations bar and the likelihood that at least some of the good earnings news was already priced into stocks. There remain tailwinds which could push growth back to trend and keep earnings from faltering: The tax cuts for consumers and businesses are just coming into effect, and repatriation efforts should begin to pick up now that the Treasury Department has issued guidance on several outstanding issues. This has translated into elevated consumer and business confidence, which had generated hope for a strong capital spending (capex) cycle. However, some leading indicators of capex have recently rolled over;

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while at the same time an increasing number of companies have cited trade-related uncertainty in their earnings conference calls; so there may be a pause in the capex cycle.

**Consumer and business confidence elevated**

**Capex plans have rolled over (temporarily?)**

## Tailwinds could lead to headwinds

A mostly-positive economic backdrop has raised inflation and inflation expectations, and could push the Fed to move more aggressively. Commodity prices have moved higher (more on the rise in oil below), the labor market remains tight, and increased fiscal stimulus has caused several key inflation indicators to move above the Fed's 2% target.

**Higher commodity prices**

**And a tight labor market**

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**Could lead to still-higher inflation**

The minutes from the most recent Federal Open Market Committee (FOMC) meeting indicated that it wasn't overly concerned about inflation at this point; although they cited tariff concerns as one basis for the pace of rate hikes to remain gradual. We don't expect a hike at the May FOMC meeting, but a June hike is a near-certainty at this point according to the fed funds futures market.

## Political winds are blowing

As is typical, we expect a continued rocky road between here and the midterm elections. Historically the average loss of House seats in the first midterm for a newly elected president has been 29 according to Strategas Research; so that potential for turnover can help contribute to investor nervousness. The average maximum drawdown by the S&P 500 during midterm election years since 1950 has been 17%, with weakness concentrated in the first three-quarters of those years. But a positive caveat is that the average subsequent one-year performance from the trough of the drawdown has been 32%. We certainly can't be sure that history will repeat itself—especially in an era like this—but any election-related weakness could be followed by a rally thereafter.

## Oil is on fire: will the economy feel the burn?

As noted above, commodity prices have moved higher, led by oil. There was a time when economists feared a run up in the price of oil. Every $10 rise was thought to weigh heavily on consumers and businesses; hurting economic growth, as evidenced by the oil-shock induced recessions of the 1970s. Yet economists have remained confident that solid growth will continue, with the International Monetary Fund (IMF) forecasting 3.9% growth in 2018 and 2019 in its report released last week. This is in spite of oil prices having more than doubled from two years ago, and climbed $30 just since the low of last summer, as you can see in the chart below. What gives?

**Oil's been on fire**

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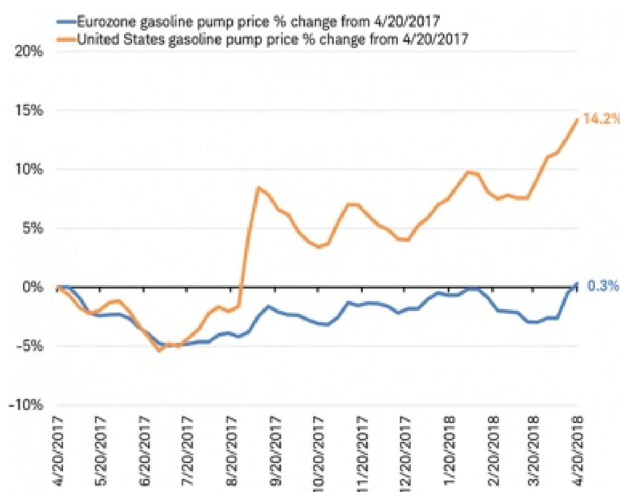
Source: Charles Schwab, Bloomberg data as of 4/23/2018.

While the doubling in U.S. oil production over the past decade means U.S. businesses stand to benefit from higher prices, and the tax cut is somewhat offsetting higher prices at the pump for U.S. consumers; other parts of the world also seem to be weathering the rise in oil prices with solid first quarter economic growth.

There are three good reasons why we believe the current rise in oil no longer means a faltering global economy:

1. The rally in oil prices has been much smaller outside of the United States, given the depreciation in the U.S. dollar. While Brent oil prices are up 11% in U.S. dollars from the start of the year through April 20, the rise is 8% in euros and only 6% in Japanese yen. Consumers in Europe and Japan are further cushioned by much higher fuel taxes, making the percentage increase in prices at the pump even less impactful. In fact, Eurozone gasoline pump prices are virtually unchanged from a year ago, as you can see in the chart below.

**Road to nowhere: Eurozone gas prices are virtually unchanged from a year ago**




Source: Charles Schwab, Bloomberg data as of 4/21/2018.

2. Robust economic growth in developed economies helps to absorb higher oil prices. Last week, the IMF upgraded its outlook for the global economy, raising 2018 GDP forecasts for most developed countries.

3. There is a key difference between supply- and demand-driven moves in oil prices. While both may be playing some role in the recent run up, a demand-driven rise is less worrisome than one driven purely by a supply shock. Emerging markets' demand remains strong and is expected to account 83% of this year's oil demand growth, according to the International Energy Agency (IEA).

The rise in oil prices is helping to lift corporate earnings. Energy companies in the MSCI All-County World Index (ACWI) are expected to report earnings growth of 21% for the first three months of the year and 70% for the second quarter relative to a year ago, according to FactSet data. However, a continued rise in oil prices could eventually begin to eat into discretionary spending by consumers, and could force central banks to tighten monetary policy faster to clamp down on the

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resulting inflation. But for now, we believe most economists would rather see oil prices rise above $70 per barrel than fall below $30.

## So what?

Headwinds for stocks have risen but tailwinds also exist, resulting in a more tumultuous environment. We believe there are enough positives to keep the bull market going but gains are likely to be slower in coming, volatility is likely to remain elevated and discipline to a long-term plan will be crucial. Avoid overreacting to the barrage of news and focus on the items that could change the actual fundamentals of the economy.

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