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generational wealth management

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After the return of stock and bond market volatility in February and March, First Trust's Chief Economist, Brian Wesbury published a [blog post] that includes the observation, "volatility itself isn't necessarily bad." This statement may run counter to our intuition, but people buy stocks to have higher gains than they could achieve through guaranteed investments like government bonds. Along with that higher return potential comes the occasional price drop. Wesbury points out that when economic fundamentals remain sound, then volatility shouldn't cause investors to panic, and that is where we still find ourselves today according to Wesbury. His analysis of economic fundamentals focuses on monetary policy, tax policy, trade policy, and spending/regulatory policy. Three of the four look strong, and one (spending) could be corrected by conscientious leaders before it's too late.

When in February the incoming Federal Reserve Chairman Jerome Powell signaled rate hikes in 2018, markets got spooked. This despite the fact the preface to the most recent FOMC statement included many positive economic assessments such as solid economic growth and employment gains. Although rate hikes can signal economic strength (otherwise the Fed would delay), they also raise the specter of inflation. A probable inflation scare thus led to a more-than-10% correction to the S&P 500. Some analysts believe that once Chairman Powell lit a fire, the complex, and often leveraged derivative instruments traders use for risk hedging (known as the VIX) also threw fuel onto the selloff, exacerbating losses.

But hikes starting from a floor of 1.25% to 1.50% don't necessarily mean excessive interest rates. In Wesbury's words, "Monetary policy will still be loose at the end of 2018.... The federal funds rate is about 120 basis points below the yield on the 10-year Treasury...and is also well below the trend in nominal GDP growth. Meanwhile, the banking system still holds about $2 trillion in excess reserves. Monetary policy is a tailwind for growth, not a headwind" (emphasis ours). Also providing tailwinds to growth are the recent US corporate tax cuts. Wesbury points out that tax cuts free up companies to invest where they may have been holding back, thus fueling the job market, or possibly share buybacks. But neither is seen as a negative.

But investors have also had to contend with saber-rattling over trade tariffs, particularly between the US and China. President Trump has made no secret of his intentions of playing hardball with US trading partners. So far it seems that he has gained some concessions, but trade tariffs generally always harm the exporting company's earnings and often lead to retaliatory measures, so some nervousness is understandable. However, Wesbury doesn't expect an all-out trade war, and we ourselves continue to hope for a positive outcome despite the messy rhetoric.

Wesbury's greatest concern is out-of-control spending by the US government. Even with the growth, we have increased our annual deficit and seem poised to do so again. "The more the government spends, the slower the economy grows" because government spending can help fuel the private sector if it's not going toward debt service at the federal level.

In summary, the concerns are tariffs and spending, both of which our policymakers control to some extent. Wesbury concludes, "Things aren't perfect, but, in no way do the fundamentals signal major economic problems ahead. The current volatility in markets is not a warning, it's just volatility."

Turning to the market, the below chart shows that toward the end of March, prices were not tracking with estimated future earnings like they had been for the previous several quarters. Wesbury points out that the earnings support prices in general, so a more normal market (based on recent activity) would see these lines converge.

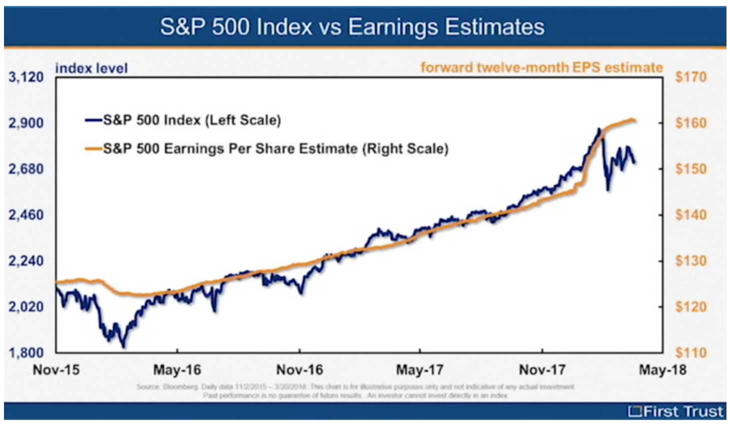

Chart source: https://www.ftportfolios.com/Commentary/EconomicResearch/2018/3/22/dont-fear-volatility

Practically speaking, each time we have seen a large drop in stocks lately, it seems that the next day has brought a rapid upswing. Attempting to time those moves is a fool's errand and would in all probability harm returns. So while we do not like seeing portfolios giving back the January gains, we still believe fundamentals remain attractive, and stock prices reasonably well supported. The primary risks we face remain the risks we have faced so far this year, namely, inflation and geopolitical events. But we have seen fear get overblown so many times that we counsel our clients to hold on to their long-term equity allocations and even to use any short-term downturns to rebalance into them.

Be well,

Art Doglione