Looking Past the Sell Off

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> *"Investing is the intersection of economics and psychology."*

—Seth Klarman

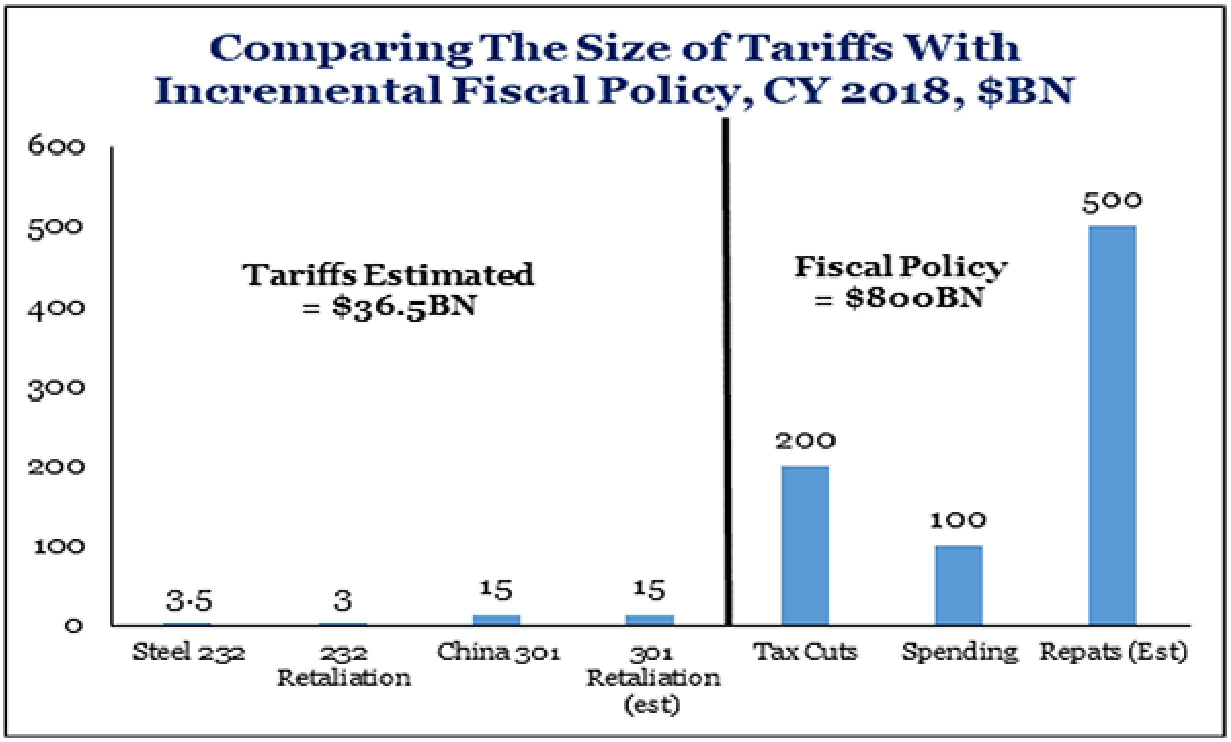
The above quote by famed value investor Seth Klarman captures the importance of identifying the economic fundamentals behind stock valuations and sentiment behind short-term market volatility like we are experiencing. The Fed, Facebook, tariffs, interest rates and revolving West Wing leadership all had a cumulative behavioral impact on markets last week. Yet, continued solid economic and earnings underpinnings continue to support the case for stocks. In this edition of *Market Spotlight* we briefly highlight some of the headlines surrounding last week's sell off focusing on those areas we are watching most closely.

The Fed: Last Wednesday, March 21st, gave markets their first glance of new Fed Chair Jerome Powell's post-meeting performance. He affirmed recent commentary by a number of Fed governors that economic growth is expected to accelerate for 2018 and 2019. This upward nudge in expected growth, inflation and interest rates is more relevant than handicapping how many more rate hikes are in the cards for 2018. They hiked rates for the sixth time since December 2015 renewing their conviction for slow but steady rate increases.

Facebook: Facebook's privacy issues were front and center last week but are likely overdone. These issues do not serve as an indictment of the entire technology sector but will remain in the headlines to see if the government creates new privacy regulations around social media companies. Also, effective September, Facebook will no longer be categorized as a tech stock as S&P has reclassified it within the new Communications Services sector along with Google. The market in general and the technology sector specifically are much bigger than just Facebook so context is crucial.

Interest Rates: Bond markets exhibited a classic risk-off rotation last week with money leaving stocks and flowing into bonds. Ten-Year Treasury yields fell from their recent high of 2.9 percent on March 9^{th} to 2.81 percent at Friday's close. Based on current conditions, 10-year yields are likely to move toward 3 percent-3.25 percent by year-end 2018. The interest rate undercurrent that most impacted the market last week was not the Fed Funds Rate or the 10-Year Treasury but LIBOR (London Inter-Bank Offered Rate). The spike in LIBOR relative to Fed Funds or 3-month T-Bills is relevant at this stage of the cycle. Rising LIBOR rates result in rising interest costs for businesses anchored to LIBOR. This bears watching in the months to come especially for the lower quality borrowers but last week's spike was likely overdone.

Tariffs: What has transpired so far is a skirmish not a trade war. The positive economic impact from tariffs is small, but the potential for an indirect negative economic impact due to retaliation with trading partners is the primary reason for last week's renewed market turbulence. A prolonged contentious debate between the U.S. and China that causes corporations to delay capital investment and hiring plans could be a jolt to recent record high business confidence. Any sustained and meaningful decline in business confidence could restrain economic and earnings growth. We think the reality will be toned down from the rhetoric but this remains a front-burner issue with little margin for negotiation error. As the chart below shows, the expected impact from Fiscal Policy on the right ($800 billion) dwarfs the expected impact from anticipated tariffs on the left ($36.5 billion). For that reason, any negotiation needs to be swift to sustain current economic momentum.



On a positive note, tariff news quieted somewhat over the weekend with discussions between U.S. and Chinese trade delegations underway and markets off to a good start for the week. Our primary concern with trade is a contentious tariff negotiation could dilute the benefits expected to accrue from tax reform. If businesses lose confidence, they could decide to sit this one out and not invest in capital or people, which would raise the risk of recession. This risk is possible but at this point, not probable.

Musical Chairs in Washington: Recent leadership changes at several key White House posts have little economic relevance. At worst they are added to a roster of issues that when combined, could impact investor confidence.

A Busy Calendar Week: We have a busy week of economic announcements this week. We highlight the three we are watching most closely:

- Consumer Confidence 11 a.m. Tuesday, March 27th
- University of Michigan Consumer Sentiment 11 a.m. Thursday, March 29th
- Chicago Purchasing Managers Index 9:45 a.m. Friday, March 30th

These are high-priority indicators this week in that they are considered “soft” indicators based on sentiment or the moods of consumers and businesses. Soft indicators such as these often tell the story of what may lie ahead. We will watch these indicators for signs that confirm recent consumer and business strength or signal stress based on some of the items we mention above.

Bottom Line: We remain in the late stages of what could become the longest bull market in history this August at over nine years. A near-term resolution to the tariff debate will be market friendly while a drawn-out debate will not. The real risk to markets from tariffs will be to the extent that they negate the benefits of fiscal stimulus; however, we do not think these risks are high. The U.S. economy is supported by pro-growth fiscal stimulus and earnings expectations remain high. Valuations are more in line with history now thanks in large part to double-digit earnings growth. Corporations have been aggressive buyers of their own shares, but a decline in share buybacks due to blackout restrictions during earnings season could temporarily weigh on share prices.

We echo our comments from our 2018 Outlook where we said stocks are transitioning from a steep-return/low-volatility regime to a modest return/rising volatility regime. The market is demonstrating renewed sensitivity by reacting in a volatile way to all issues large and small, so we will continue to do our best to provide context and relevance. One of the greatest challenges any investor faces is to resist the cross-currents or winds that could blow you off course from your long-term plan. Stay invested, focused and true to your compass.

Sources: Strategas Research Partners, Evercore ISI, FactSet, Goldman Sachs Global Investment Research, Morningstar, BCA Research, Standard & Poors

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