Rising Yields Begin to Bite

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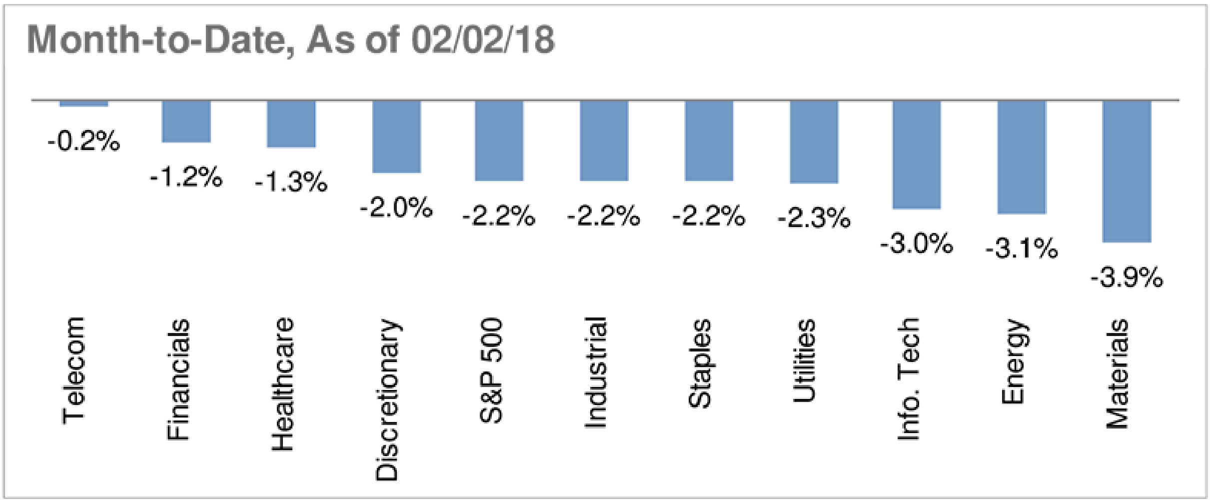
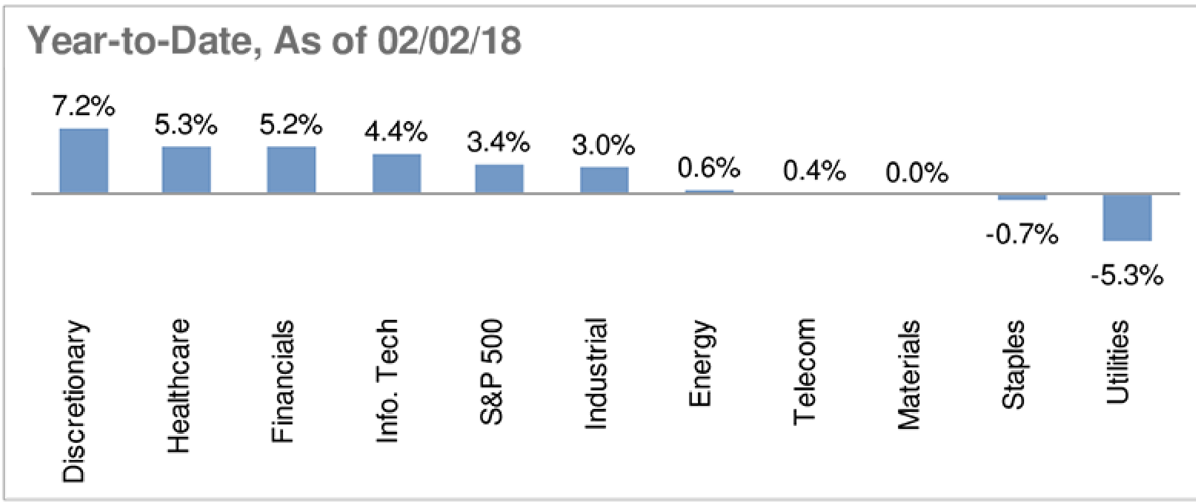
Volatility returned to global stock markets last week with the S&P 500 declining -3.85 percent from its Jan. 26th all-time high with international markets following suit. Volatility has carried into this week, but we believe it will be contained. Rising bond yields are the primary (but not only) catalyst behind the decline. In this edition of *Market Spotlight* we discuss volatility and corrections from an historical context while framing our forward expectations with a positive fundamental backdrop.

The chart below offers a glimpse of YTD returns for the S&P 500 and each of its sectors.

S&P 500 Index Sector Returns





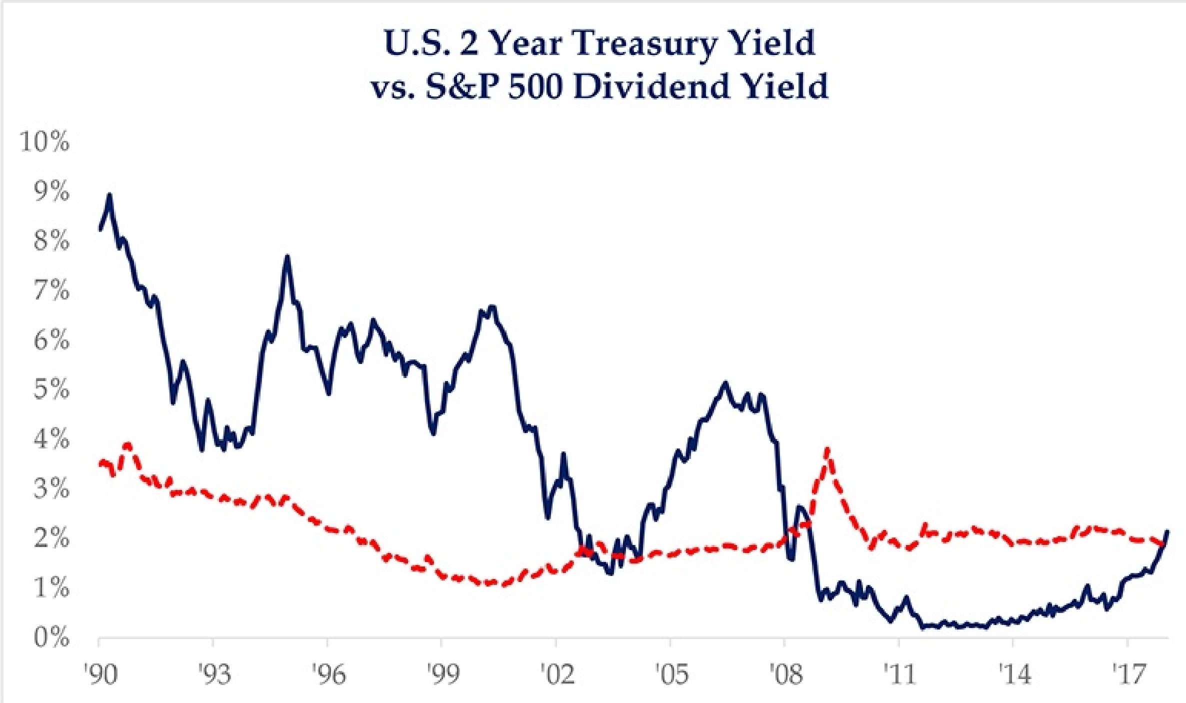
Drawdown Catalysts: Corrections need context. What we have seen so far has been minor and simply resets the markets to mid-January. With that said, we look at catalysts behind this renewed volatility and expect it to occur with increased frequency in 2018.

1. **Rising Bond Yields:** We indicated in last month's *Market Monthly* that we expected 10-year Treasury yields in excess of 2.75 percent would impact stock prices. This has happened sooner than expected, but we do not believe there will be a cascading effect given continued economic strength and earnings growth. Yields on the 10-year Treasury began the year at 2.41 percent but have quickly risen to 2.85 percent today, Feb. 5th. This same trend is occurring among most other developed markets, and the European Central Bank is expected to decrease their pace of monetary easing. The primary prompts to last week's increase in bond yields were:
    - **The Fed:** 31st was Janet Yellen's last meeting as Federal Reserve chairperson with incoming Fed chairperson, Jerome Powell, being sworn in this morning (Feb. 5th). The Fed continues to sound hawkish signaling three rate hikes in 2018. Last week, bond markets finally listened and began repricing, sending bond yields higher. Historically, markets have experienced short-term bouts of volatility during the first year of a new Fed chair with median S&P 500 returns of 11 percent and median drawdowns of -13 percent. Investors cannot plan for this but should not be

surprised by it.

    - **Firming Inflation:** We reiterate our reflation theme introduced last month as critical to our 2018 outlook. This was supported by last week's jobs report, which revealed unexpected wage inflation with average hourly earnings jumping from 2.4 percent to 2.9 percent. This was not impacted by the large and growing roster of companies paying one-time bonuses from the recently enacted tax reform package. Oil prices remain firm, and global prices for manufacturing inputs are climbing steadily, especially in Europe. The Fed's 2-percent inflation target has been mistaken as a bullseye. They will continue hiking rates as long as inflation is 2 percent …ish.

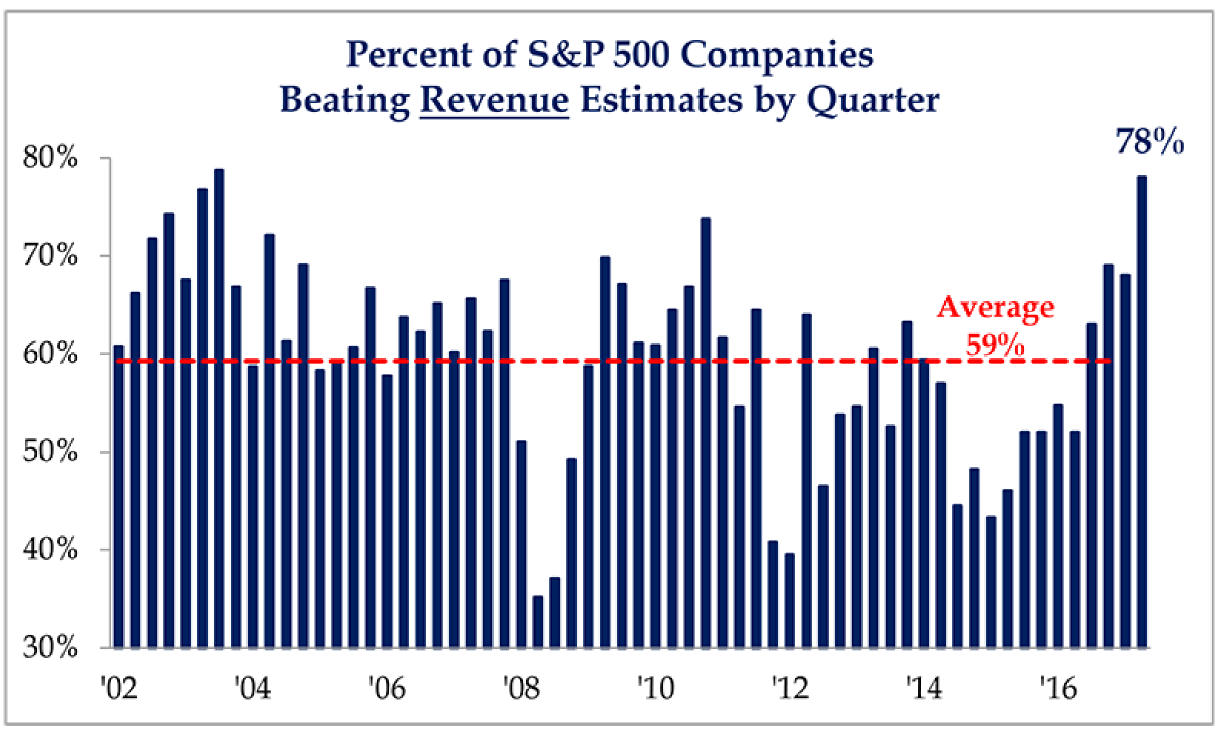
2. **Excessive Optimism:** Recent indicators reveal record high levels of optimism among investors and business leaders alike. Accelerating economic growth and tax-reform optimism have fueled animal spirits generating uninterrupted market returns with the lowest volatility in 90 years. The economic story remains strong enough to remain optimistic, but we suspect upcoming sentiment surveys to curb their enthusiasm slightly.
3. **Overdue Pullback:** Last week ended the record streak for number of days without a 3-percent drawdown for both U.S. and Global stock indices. Bull markets don't die of old age so we think it is healthy for the Bull to catch its breath. Further modest pullbacks would not surprise us and not change our position that any drawdowns would be within a continuing but maturing bull market.
4. **New Competition for Stocks:** A final thought on rising bond yields can be captured in the chart below. It has been almost 10 years since 2-year Treasury notes have yielded more than the S&P 500 dividend yield. The unwinding of Fed policy may have the unanticipated effect of ending the "risk on/risk off" relationship between stocks and bonds. We have seen this so far in 2018 with an unusual positive correlation between stock prices and bond yields. This could pose a more challenging environment for asset allocation as bonds are displaying a diminishing effect as a hedge against risk assets.



Fundamentals Remain in Tact:

The following items continue to support a pro-risk stance for 2018:

Q4 earnings and revenue are beating estimates by 75 percent and 78 percent respectively. The chart below simply shows business is good for S&P 500 companies with almost 80 percent of S&P companies beating revenue expectations.



- 2018 earnings estimates have been increased by over 5 percent since the beginning of earnings season, the highest on record for the first month of the year

- 94 percent of developed economies of the world remain in expansion mode
- Pro-growth corporate tax reform is expected to add as much as .75 percent to GDP growth and 5 percent to S&P 500 earnings growth

Takeaway:

The economy and markets are finally behaving as they would in a normal economic cycle, and this is a very healthy thing. Normal bouts of interest rate and stock market volatility, as we are seeing now for the first time in two years, should be expected. Normalcy is slowly being restored to markets. Simultaneous execution of tighter Fed policy coinciding with pro-growth corporate tax reform remains the biggest story of 2018.

As we have said before, we think 2018 marks a late cycle turning point and expect stocks to slowly shift from a steep return/low volatility regime to a modest return/rising volatility regime. The global financial system has been repaired. The recovery that began in the fall of 2014, once the Fed ended quantitative easing, continues. As the recovery enters later stages, reflation will nudge global markets further ahead at a modest pace. As long as the positive fundamental backdrop remains in place we would not view recent market action as a catalyst for concern. This has been one of the more telegraphed pullbacks we have seen in years and welcome it. Short-term volatility is normal and does not warrant changing a prudent long-term investment plan. Stay the course.

Sources: Sources: Strategas Research Partners, Evercore ISI, FactSet, Barron's, CNBC.com

This piece is produced by BB&T's Wealth Portfolio Management Team.