After strong returns in 2017 and a remarkably strong January 2018, stock market volatility has increased and equities are now negative year-to-date. In effect, what we're witnessing is a struggle between strong business conditions, a synchronized global expansion and strong corporate profits versus the increasing fear of a serious trade war, a shift from U.S. quantitative easing to tightening and severe negative news about leading technology companies. As we look ahead and try to balance these conflicting forces, we come to the conclusion that strong business and increasing corporate profits will probably outweigh trade wars and other fears.

Economic Growth and Corporate Profits

In the U.S., tax cuts and fiscal stimulus have added fuel to a strong economy. As a result, U.S. business is strong and getting stronger. Corporate profits are increasing significantly. Consensus expectations for earnings increases are high in the U.S. at +26% for CY 2018 and we are also beginning to see estimates for further considerable increases for 2019. Capital expenditures are responding to stimulus and increasing, and as a result, productivity is improving. Business and consumer sentiment indicators are at or near peak levels, inflation has remained subdued, and there are few serious economic imbalances apparent. In short, a recession is not a near-term concern. Internationally, real economic growth rates in aggregate are higher than in the U.S. and earnings growth is accelerating at rates not seen since prior to the financial crisis. In addition, some large economies (e.g. the European Union and Japan) are still employing quantitative easing, providing a friendly backdrop for continued growth.

Concerns

The enhanced volatility this year is due in large part to the uncertainty that the current Administration generates and greater investor focus on what could go wrong. What the market is worried about now is the following:

Tariffs & Protectionism: The market is not reacting to the trivial amount of tariffs proposed by the U.S. and China, but rather to the possibility of a major escalation. A trade war is totally illogical, and we do not expect one; however we are in uncharted waters and serious mistakes are possible.

Twin Deficits: The U.S. federal budget deficit will rise significantly due to tax cuts and higher fiscal spending. With an increased fiscal deficit it is almost inevitable that the current account deficit will increase as well. The additional supply of Treasury Bonds to fund growing deficits, in conjunction with the beginning of tightening by the Fed, could impact bond prices (lower) and yields (higher). In the long run, meaningfully higher interest rates are not good for equities.

Regulation: Market leaders, specifically in technology, have come under scrutiny: Facebook in the U.S. for a breach of trust; Google in Europe for perceived monopoly power; and Amazon for "unfair business practices". Final outcomes will take time and are unknown at this time, not only to the companies and their competitors, but also to the regulatory bodies themselves.

Current Positioning

Our response over the last year to a very supportive environment for equities and political uncertainties has been to take some profits, reduce exposure to long-term growth investments, and to take advantage of cheaper non-U.S. equity markets which have priced in lower expectations. Non-U.S. equity markets not only have lower expectations, but also remain more inefficient, a dynamic that allows us to reinvest at more attractive long-term expected returns.

Client portfolios currently maintain neutral allocations to long-term strategic asset allocation targets, indicating what we view as a balance between strong economic growth prospects, political uncertainties and other risks. Our mix of U.S. and non-U.S. investments within long-term growth investments is balanced at roughly 50/50, a substantial shift toward non-U.S. exposure compared to a year ago. Our allocation to long/short equity managers is unchanged; however our research continues to focus on discovering highly differentiated managers whose unique strategies provide compelling benefits to portfolios. This would include managers investing in less efficient (e.g. international and global) markets and managers with proven short capabilities. In fixed income, we continue to be positioned with an emphasis on short(er) duration, and we remain comfortable with taking moderate credit risk with managers that satisfy the requirement of being able to protect and preserve capital. As always, we remain vigilant with respect to the investment landscape, and continue to assess both the risks and the opportunities that develop over time.

As Always

We appreciate your patience and the trust you've reposed in us. Please let us know if you have questions or concerns.