



The Colony Group

MARKET PERSPECTIVES

► QUARTER ONE 2018



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Financial markets faltered during the first quarter of 2018 following several quarters of relative tranquility. There were numerous factors that conspired to raise investors' angst: rising interest rates; burgeoning signs of inflation; geopolitical risks, primarily originating from Russia and North Korea; and escalating trade-dispute rhetoric. Volatility rose in

early February as a result of these factors, pushing U.S. stocks into correction territory, defined as a decline of 10% or more, for the first time since January 2016. Globally, stocks registered their first quarterly decline since the third quarter of 2015.

Bonds struggled during the quarter as well, belying their traditional role as a hedge during tumultuous times. U.S. interest rates moved higher for the third consecutive quarter, boosted by Federal Reserve rate hikes and an unexpected jump in both the consumer price index (CPI) and wage growth that stoked investors' concerns over inflation.

The 10-year U.S. Treasury note saw its yield rise past 2.9%, its highest level since early 2014. The rise in yields stalled in March, however, and the 10-year finished the quarter a shade below 2.75%.

For the remainder of this newsletter, we examine more closely the rise in volatility and focus on one of its causes: trade tensions.

Volatility Strikes Back

Some investors were lulled into a sense of complacency last year following the equity markets' steady run higher. These investors were abruptly awakened during the first quarter, as volatility returned after being largely dormant over the past few years. As we approach the later innings of the current cycle, we expect volatility to remain elevated, albeit not at the extreme levels attained in February.

Markets were historically calm last year. The S&P 500's volatility index, often referred to as the VIX or "fear index," recorded its lowest average daily closing price of any year and hit an all-time low of 9.1 in November. Not once last year did the daily movement in the S&P 500 rise or fall by more than 2%. In contrast, there have been six such days in the first quarter of 2018 alone. Due to this relative serenity, the stock market rose steadily throughout 2017.

Recall that in our previous *Investment Perspectives*, we highlighted that the S&P 500 had reported 12 consecutive months of positive total return for the first time in history.

Signs that inflation is starting to accelerate were seemingly the initial catalyst for February's spike in volatility. The VIX rose to a high of 37 on February 5th and remained above its historical average of 19 for most of the remainder of the quarter. Investors became concerned that accelerating inflation would cause the Federal Reserve to fall behind the curve, requiring it to raise interest rates more aggressively than expected. This might choke off growth and possibly thrust the U.S. economy into recession.

While it is not uncommon to see volatility rise in the later stages of a market cycle, there are other factors behind the recent increase. Rising inflation, tightening monetary policy, geopolitical risks, and growing protectionism have combined to reset the volatility regime. We encourage investors to become acclimated to this set of circumstances, as none of these risks currently appear poised to reverse anytime soon.

WHAT THIS MEANS

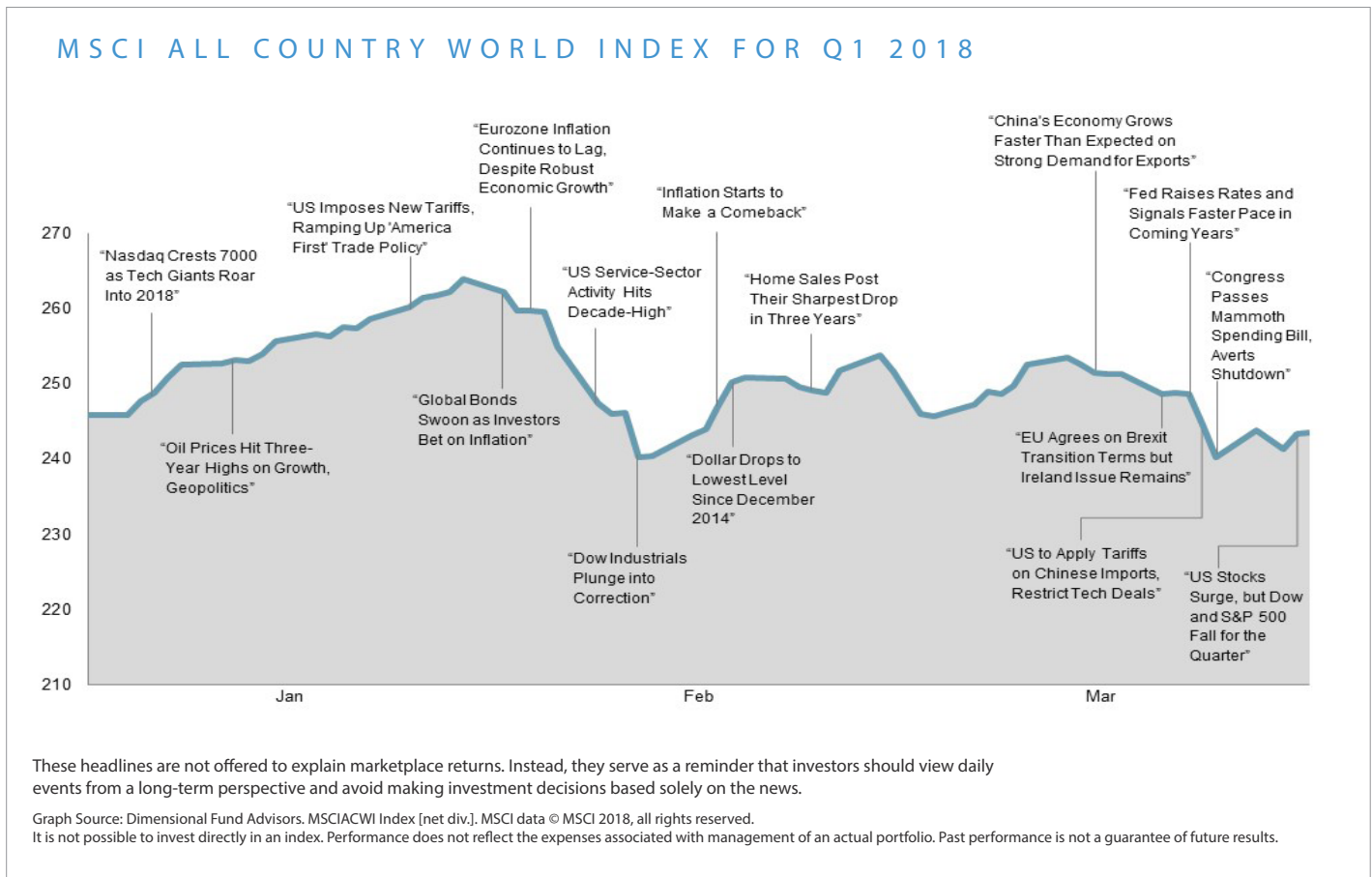
The jump in volatility during the first quarter felt more painful than it should have, likely the result of the impressive, low-volatility rally

experienced by risk assets during the past several years. This run was fueled by subdued inflation, low interest rates, and steady economic growth. As we enter the later phase of the cycle, these conditions are beginning to unwind. Unsurprisingly, investors have reacted negatively to this budding regime change.

The rise in volatility does not necessarily signal that the cycle is coming to an end soon. During the last nine episodes where the VIX rose by more than 10% in a 13-week period, the economy continued to expand for an additional 41 months on average. Moreover, none of these episodes marked the start of a bear market, and stock prices were higher a year following the spike in eight of the nine last occurrences.¹

The fundamental underpinnings of the U.S. equity markets generally remain sturdy. Earnings growth is strong, and analysts have raised forward estimates due in part to the reduced corporate tax rate. Valuations appear rich in some respects but are supported by historically low interest rates. As the cycle transitions to this later phase, we believe it may be extended by the arrival of fiscal stimulus in the form of the \$1.5 trillion tax-cut package. Nevertheless, we expect volatility to remain elevated relative to last year's abnormally low levels.

¹ Canally, "Late Innings," U.S. Investment Strategy, BCA Research Inc., Feb. 26, 2018, p. 6.



Trade Wars

The quote “nobody wins in a trade war” is rapidly becoming hackneyed; however, this is an appropriate time to revisit its thesis. Economists agree that current global trade policy is imbalanced. The question of whether and how to make trade fairer is more nuanced.

A component of President Trump’s America First agenda calls for free, fair, and reciprocal trade. The administration did not announce much on this front in its first year in office. That has changed this year with the announcement of new tariffs: first on washing machines and solar panels and then on steel and aluminum. While these initial measures were broadly targeting U.S. trade partners, more recently, the administration has narrowed its focus to China by announcing tariffs on a range of Chinese products totaling \$50 billion in annual exports. As we write this newsletter, there are reports that the President has asked the U.S. Trade Representative’s office to consider tariffs on an incremental \$100 billion in Chinese imports. China announced reciprocal tariffs on an equal amount of U.S. imports and has indicated that it will match any new tariffs dollar for dollar. Some investors and economists fear that we are moving towards a trade war between the two biggest global economies.

WHAT THIS MEANS

The Trump administration is turning its attention towards trade after largely staying away from it for the first year of the president’s term. President Trump has wide latitude to regulate trade outside of Congressional oversight, as current law leaves him relatively unconstrained. His recent actions have created a greater level of uncertainty in the financial markets. While other factors are also at play, investors have marked down U.S. equities by more than 5% since the White House announced tariffs on steel and aluminum.

It appears that the administration may be playing a game of “chicken” with China. Each country has announced steep tariffs against one another but may have intentionally allowed for enough time before the tariffs go into effect in early June to negotiate a compromise.

The biggest unknown factor is the level of China’s resolve. President Xi Jinping, himself a nationalist, may be unwilling to compromise at the risk of losing face with his compatriots due to the perception that he is yielding to U.S. pressure. We believe that the recent back and forth between the two largest economies in the world could just be posturing, with each side trying to gain a negotiating advantage. Certainly, both leaders understand the repercussions of a trade war. Regardless, the markets are likely to remain on edge pending a resolution.

Early trade arrangements, particularly those made with emerging economies such as China, were understandably tilted in favor of the less developed country. Free and open trade would likely have failed as America’s mature companies, that have achieved huge economies of scale, dominated their less mature emerging-market competitors. The U.S. entered into these slightly lopsided arrangements not from pure generosity, but with an anticipation of future benefit to U.S. industries. Policymakers foresaw the opportunity associated with gaining access to more than one billion consumers, as China increased its per capita wealth, in hope of creating new markets for our iPhones, automobiles, movies, music, and more.

Today, China and its corporations are much more competitive. The Trump administration, acutely aware of this, feels that it is high time to level the playing field. Its recent actions are a step in this direction and begin to fulfill a major campaign promise.

Conclusion

The equity markets appear to be transitioning to a new phase of the cycle. Indeed, last year’s popular trades, such as selling volatility or investing in FANG stocks (Facebook, Apple, Netflix, and Google), have stumbled this year. It is normal for volatility to rise during such leadership transitions.

We appreciate that these periods can be frightening to investors. Nevertheless, it is important during volatile times to evaluate without emotion the fundamentals of the economy and investment markets.

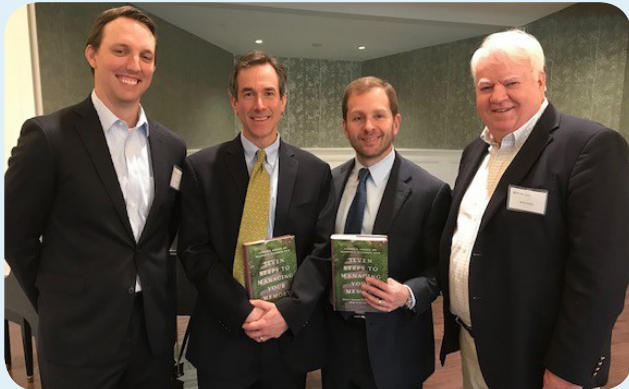
To this end, we believe that the environment remains constructive for risk assets, as earnings growth is accelerating, fiscal policy has turned stimulative, and monetary policy remains accommodative, despite recent rate hikes and the removal of quantitative easing. Many strategists believe that we are in the later innings of the cycle. History shows that these late-cycle periods can produce the strongest gains and typically outlast expectations. We will continue to monitor risks closely and stand at the ready to change our outlook as facts change.

COLONY SPOTLIGHT

▶ Committed to supporting healthy lives

The Colony Group hosted a fabulous client event featuring Dr. Andrew Budson, M.D., a renowned neurologist, and expert in Alzheimer's disease and dementia. An engaging, informative speaker, Dr. Budson presented actionable insights from his book, *Seven Steps to Managing Your Memory* to clients in Naples, FL.

Michael Nathanson co-authored *Helping Clients Face Alzheimer's Disease and Dementia* with Dr. Budson and Shellie Kurek Peters. [Read more.](#)



▶ Michael Nathanson Honored at the Gray Gala

Colony's Michael Nathanson was recognized for his service to the National Brain Tumor Society at their annual Gray Gala on March 23. Michael served on their Board of Directors since 2011 and was their Board Chair from 2013 to 2018. He has been a passionate advocate, spokesperson, and volunteer for many years.



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