Trust Company Oklahoma

INVESTMENT PERSPECTIVES

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The Return of Volatility

Do you remember the market in 2017? Probably the single most notable fact about it was its lack of volatility. There were small, steady gains many days, and no peak-to-trough drops that were even close to a 10% correction. Ah, the good old days!

In 2018, we've experienced two 10% corrections. In fact, as we ended the year in the midst of the second correction, we all watched and worried as the market inched closer to a 20% drop. You see, if the market drops 20%, we'll start referring to it as a bear market – and somehow that will be infinitely worse than simply being down 19%.

Clearly, investors' opinions have changed over the past 12 months. Let's examine the major factors that currently weigh heavily on all of our minds:

• **The Federal Reserve's interest rate increases** – since December 2015, the Federal Reserve (the Fed) has raised the Federal funds rate nine times. While the current target rate (2.25% - 2.5%) is still low by historic measures, investors worry the Fed will tighten too much and cause a recession. Economists and market strategists are theorizing about what rate would be neutral, i.e. the rate that would not help or hurt our economy's growth. Of course, the real concern is that the Fed will take rates higher than the neutral rate and our economy will enter a recession.

• **Global tightening** – it's not just the Fed that is raising rates. Currently more than half of the world's central banks are in a tightening phase. This implies that the growth rate of the global economy will slow and limit global profits. Remember that almost half of the S&P 500 revenues are from outside the United States. So, yes, slower worldwide growth matters.

• **The Fed's unwinding of its balance sheet** – the Fed is currently reducing its balance sheet by $50 billion per month. If you believe that Quantitative Easing (QE) helped the economy and the market, it's hard to believe that the unwinding won't have the opposite effect. Of course, the Fed is unwinding its $4.5 trillion bond portfolio at a much slower pace than when the Fed first increased the size of its portfolio.

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• **Flattening of the yield curve –** the yield curve has inverted before every recession since 1970. Short-term rates are rising because they are highly correlated with the Fed funds rate, which has been increasing, as described above. The 10-year Treasury yield has not increased significantly in the past 10 months, as that yield tends to reflect growth expectations for the U.S. economy. Higher short-term rates without a corresponding increase in longer-term rates means that the curve has flattened. If the two-year yield increases above the 10-year yield (10/2 spread), it will mean that the yield curve has inverted and the risk of recession is higher. Fortunately, the yield curve is still upward sloping (i.e. positive 10/2 spread), meaning longer-term rates are currently higher than short-term rates.

• **Peak earnings growth –** during the past year, S&P 500 earnings increased over 20%. A significant part of this growth was attributable to lower corporate tax rates. Now that these tax rates have been in place for a year, we will no longer see year-over-year gains that are as significant.

• **Trade wars –** costs have increased on certain imported goods due to higher tariffs. This has affected both consumers and those U.S. producers who depend upon the imported goods in their manufacturing process. In addition, trade wars and tariffs disrupt the supply chain of U.S. companies. The U.S. and China are currently negotiating tariffs. Investors are hopeful that a tariff deal will be finalized sometime in 2019. However, until a deal is reached, the uncertainty of these negotiations will continue to weigh on the markets.

• **Stronger dollar –** the dollar has strengthened for many reasons, including: 1) the United States' superior economic performance relative to other countries, 2) the fact that U.S. interest rates are higher than most other developed nations, and 3) the impact of the ongoing trade war with China. A stronger dollar makes our exports more expensive and imports cheaper. Both of these factors hurt domestic production.

• **Government uncertainty –** regardless of which side of the aisle you're on, government shutdowns, a revolving-door White House, and Twitter threats directed at specific companies as well as the Fed chairman don't inspire investor confidence.

• **High corporate debt –** corporate debt has hit record-high levels as a percentage of GDP. In addition, a record percentage of investment-grade debt is rated BBB, the lowest rung. If rates increase or the economy enters a recession, this debt could be problematic as it could be downgraded in a recession.

• **Increasing government debt –** lower tax rates and increased government spending are expected to result in trillion-dollar deficits by 2020. It's not normal to run such large deficits this late in a business cycle, when unemployment is low and corporate profits are high.

• **The length of the business cycle –** if we don't enter a recession in 2019, we will be enjoying the longest expansion in U.S. history. Of course, long expansions create worker shortage concerns that could result in wage inflation.

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• **Decline in oil prices –** As the world's largest producer of oil, capital expenditures slow significantly as the price of oil drops. In addition, the oil sector is responsible for a significant amount of outstanding high-yield debt. That debt becomes riskier with oil prices in the $40 price range.

THERE ARE BRIGHT SPOTS

Lest we sound too bearish, there are plenty of counter-arguments that allow us to stay invested. Most notably:

• **Severe bear markets usually occur with recession –** bear markets in a growing economy average a 24% drop from the high, while bear markets accompanied by a recession average a 37% drop. While the growth rate of the economy is slowing as we come off the sugar-high of low taxes and increased government spending, we still expect positive economic growth in 2019. Over the next year, growth should continue to move closer to our long-term trend growth rate of 2%.

• **Earnings still increasing –** while the growth rate of earnings has peaked, earnings have not. In the absence of a recession, earnings should still grow by 6 to 8% in 2019.

• **Valuations are more attractive than last year –** since last year, earnings have increased and market multiples have decreased. For long-term investors, this implies cheaper stocks. The S&P 500 is currently selling for 17 times trailing 12 months earnings, roughly equal to the average valuation level over the past 40 years. In December, 2017, the market was selling for 22 times earnings.

• **The yield curve is still upward sloping –** while the spread between the two-year Treasury and the 10-year Treasury yield is declining, the spread is still positive which implies new loans are still profitable for banks. Even if spreads do invert, there have been times (1989 and 2006) when the stock market rallied for another 18 to 20 months after inversion before peaking.

• **Benefits of trade disputes –** it's possible that our trade conflict with China will have positive results. Most notably, Chinese markets could become more open to U.S. companies while China could be forced to increase its respect for intellectual property rights.

• **The Fed is slowing down its pace of rate hikes –** at its most recent meeting, the Fed projected only two more rate increases next year and one more after that. Investors believe the Fed will only increase rates once in 2019. The Fed is acutely aware that the stock market is currently selling off due to its tightening of financial conditions (i.e. raising rates).

• **Decline in oil prices –** Lower oil prices also mean lower gas prices at the pump – always a positive for consumers.

So, where does this leave us? See the chart **below** for perspective. We had 20 days in 2018 when the market was up or down by at least 2%. In 2017, there were no such days.

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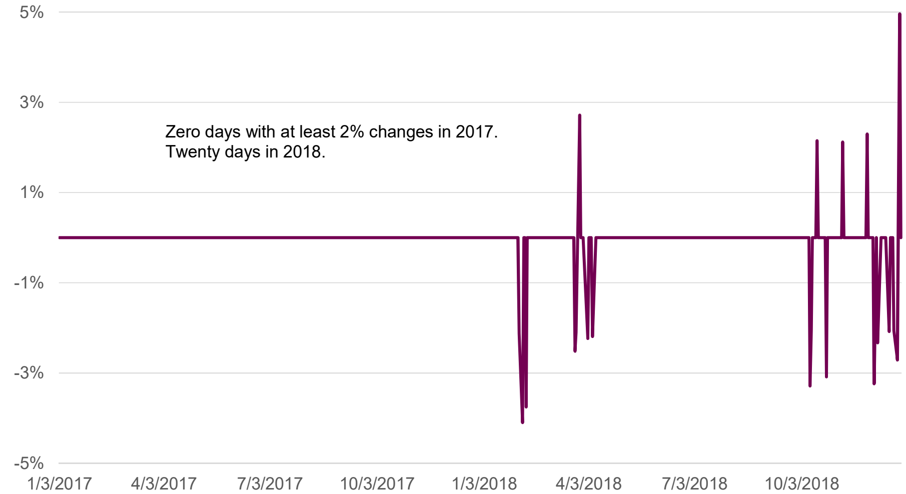
S&P 500 - Days Plus / Minus At Least 2%



To the extent that volatility represents uncertainty – the fight between the bulls and the bears, it shouldn't be surprising that volatility is high. Given we're late in the business cycle and also late in the Fed's tightening cycle, we should expect volatility to continue in 2019.

If forced to play the role of prognosticator, I would suggest that low oil prices and a falling stock market will help keep inflation in check, even in the face of low unemployment. Slow growth and low inflation will put a ceiling on how high interest rates can go, helping calm investor Fed-related concerns.

At the same time, slower earnings growth, pessimism about the business cycle, and uncertainty about fiscal policy, monetary policy, and trade policy will put caps on the best-case scenario for stocks. Ultimately, it's the unpleasant part of the investing cycle, recognizing that we're no longer in the sweet spot of the business cycle. Many of these issues have the potential to create bouts of short-term volatility – situations that will likely give us the opportunity to increase our allocation to equities at more attractive prices over time.

We will continue to monitor the markets and adjust your portfolio to be in the best position for whatever the market and the Fed have in store for us. We sincerely appreciate your vote of confidence during these challenging times.