MID-QUARTER UPDATE – MAY 2018

It continues to be an interesting year for the markets. As of this writing, stocks are slightly positive for the year, with the S&P 500 up about 2%. Bonds have had more of a struggle, with the Bloomberg Barclays Aggregate Index down 2.7% and some bond indices down as much as 5%. Volatility has settled a bit after surging during the first week in February, and the CBOE Volatility Index (VIX) has returned to a more "normal" level of 13.5 after hitting a panic high of 37. Despite moderating volatility, stocks (measured by the S&P 500) continue to churn in a sideways pattern and remain 5% below the all time highs posted early this year and below the recovery highs of March.

The economy is firm and corporate profits from the first quarter are robust, but these positive signs are checked by an accompanying rise in interest rates. Strong PMI survey results, unemployment below 4%, and a 2018 real GDP growth forecast of 2.7% are a medley of data that illustrate a healthy economic backdrop. Corporate earnings are beating estimates and reflecting the tax cut benefit. According to FactSet, 78% of S&P 500 companies have reported a positive earnings surprise and 77% have reported a positive sales surprise in their earnings releases. FactSet notes that this is the highest percentage ever recorded since they began tracking the metric back in 2008. The downside to this positive backdrop is that the Fed continues to normalize interest rates and, appropriately, remove the accommodative near zero interest rate policy initiated in response to the Great Recession in 2009. Currently the Fed Funds target rate is 1.5% to 1.75% after a 25 basis point increase in March, and another 2 to 3 interest rates hikes are expected this year. Bond yields have moved a considerable amount, as well. The 10 year Treasury yield recently hit 3.1%, up from 2.4% at the beginning of the year. Higher borrowing costs could have some dampening effect on economic activity, and at some point more attractive bond yields may begin to entice investors to shift out of stocks and into fixed income.

For those intending to travel this summer, travel costs are changing. With low inventory levels and sound economic activity, oil is setting recovery high levels over $70 per barrel compared to below $40 in early 2016 and up $20 per barrel from the start of the driving season last year. Oil is priced in dollars, and the dollar has strengthened notably over the past month, moving from 1.25 per Euro to 1.17 and rising. One reason for the increase is the difference in interest rates between the U.S. and the rest of the world. A ten year bond in Germany yields 0.5% versus 3% for a corresponding U.S. Treasury. Maybe it is time to take that European vacation instead of a cross country road trip this summer?

"Sell in May and Go Away" is an old Wall Street adage indicating that the best returns come in the first part of the year. While we contend that there is no true validity to it, at least in modern times, there is long term data that backs that claim, and given where we are on the calendar I wanted to share some interesting research from SentimenTrader. This study shows that since 1950 there is a huge dispersion between stock market returns accrued from November to April versus from May to October, the latter of which resulted in an average annual return near zero.

For what its worth, a strategy that sells and waits out the latter half of the year would have left investors disappointed in the past two years, and is presented here tongue-in-cheek only because it is interesting and not because we expect the next six months to be any more difficult simply because of the calendar.

As the investment world hunkers down in a trading range caught between the economic and fundamental tail winds and higher interest rate headwinds, we expect elevated levels of realized volatility to persist intermittently this year. Volatility is a normal part of investing, and our systematic approach to managing investments and client risk parameters will continue to be our primary focus as we look to smooth the ride for our clients while continually searching for opportunity.

All the best,

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