MALVERN CAPITAL MANAGEMENT

First Quarter 2018
Market Review and Outlook

April 2018

The Market Takes a Pause

The widely accepted definition of a market correction is a decline of a market index by 10% from its high-level price. All three major indices, the Dow Jones Industrial Average, the S&P 500 Index and the Nasdaq all officially entered correction territory during the first quarter 2018. The corrections occurred after robust advances in the month of January in all the indices as each index achieved multiple new highs in the first month of the year.

But February 2018 turned ugly. After peaking on January 26, 2018, the Dow Jones Industrial Average quickly dropped 3,256 points or 12.2% by February 9, 2018. Likewise, the S&P 500 Index dropped 340.18 points or 11.8% over the same time-period. Finally, at the same time the technology heavy Nasdaq Index fell 875.10 points or 11.6%. All the indices recovered sharply off their lows by February 27th and regained most of their losses. However, as we entered March, selling once again appeared and the indices gave back some of their recent recovery. Still, the indices closed the quarter off their lows. The Dow closed at 24,103, the S&P 500 at 2,640.87 and the Nasdaq 7,063.45 *(Source: Morningstar Direct)*.

What caused the dramatic selloff in the stock market during the first quarter 2018? There may be a few specific reasons we can point to for the stock market's decline. One reason for the selloff was data found in the January jobs report released on February 2, 2018. The jobs report showed that wages were beginning to rise for the first time in many years. Although good news for workers, rising wages are an indication of inflation and inflation is a signal of potentially higher interest rates ahead. Another reason cited for the selloff was a rise in longer term interest rates. In late January and early February, we saw longer term interest rates on U.S. government notes and bonds rise. Such a rise in interest rates scared equity investors and contributed to the selloff.

The Federal Reserve was not quiet about its intentions regarding interest rates either. It was widely believed by investors at the beginning of 2018 that the Fed intended to raise interest rates three times in 2018. The market priced in the expectation for three rate hikes this year and accepted the Fed's tightening plan which was seemingly conveyed from recent Federal Reserve meetings. However, news began to come out that one of the Federal Reserve governors was hinting that a fourth-rate hike in 2018 was possible. Investors were not prepared for the additional rate hike and equity selling occurred as a result.

In addition, news surfaced that the Federal budget deficit could reach $1 trillion in 2018 and that was before considering the impact of the recently passed tax cutting legislation. Rising deficits are also a sign that interest rates could rise in the future as there would be more supply of U.S. government debt issued.

Lastly, the market has sold off in response to the possibility of a global trade war as the Trump Administration had initially proposed imposing tariffs largely on steel and aluminum imports. The Administration later floated the idea of imposing tariffs on technology, apparel and other imports from China. Certainly, the countries having tariffs imposed on them will respond by imposing tariffs on goods coming from the United States. The equity markets are a little unsettled for the potential for a trade war.

Despite a possible trade war, many of the reasons for the selloff seem to center around the increasing of interest rates. From a positive standpoint, rising interest rates are a signal that the economy is strong and a strong economy leads to rising stock prices.

What is also important for rising stock prices are strong corporate earnings. Corporate earnings have been improving in recent quarters and will likely continue to improve as a result of the recently enacted corporate income tax rate reduction. Most corporations will benefit from the reduction in the corporate tax rate declining from 35% to 21%. As we enter the first quarter reporting period (early to mid-April 2018) we will likely start to see companies give some earnings guidance which reflects the impact of the declining tax rate on their bottom lines. It does not appear that the impact of such earnings outlook is priced into companies' valuations and this should provide some catalyst to higher stock prices.

The selloff was probably overdue and should not be a cause for concern longer term. We believe the economy is healthy, earnings are good and should be improving and investor sentiment is positive. Prior to the first quarter selloff, investors had experienced tremendous gains since the November 2016 Presidential election. Over that time period of around 14 months, market volatility was low and in 2017 the Dow Jones Industrial Average hit 71 new highs. It is not alarming to experience some profit taking and investors seized on fears of rising interest rates and a potential trade war to take profits.

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