## The Markets Stabilize Following a First Quarter Correction

In the first quarter 2018, the markets experienced a long-awaited market correction. It was a short-lived correction lasting just a few weeks from late January through early February 2018. Although it appears as if the lows were reached in early February, since then we have experienced continued volatility in the markets. It is possible that new lows could be achieved but it is more likely that we are now in a trading range. Over the past few months the markets are unable to reach new highs but are also able to avoid recording new lows.

The market correction was prompted by rising interest rates, inflation fears and threats of trade wars with Europe, China, Mexico and Canada. Interest rates have backed off a bit from their recent highs and inflation fears have subsided for now. But we need to keep our eyes on both of these issues. The real wild card is the possibility of trade wars with our largest trading partners in which nobody will win. Most of the sharply down-market days in the second quarter were initiated by news of some proposed tariff coming from the Administration. Tariff threats are likely to continue. Whether these threats are a carefully planned negotiating ploy by the President or simply irresponsible rhetoric ignoring economic history, they greatly impact the current direction of the equity markets.

## Beware of Rising Interest Rates

Although interest rates have backed off of their recent highs, the Federal Reserve has been tightening credit by raising the Fed Funds rate gradually since December 2015. It is expected that the Fed will raise rates at least two more times this year. It is also anticipated that the Fed will continue raising rates in 2019. The Fed's dual mandate is to maximize employment and combat inflation. Subtle signs of inflation have been seen in recent months such as increases in the prices of materials used by manufacturers and increasing wages.

We also cannot ignore the fact that the Fed has begun letting its balance sheet shrink. After four rounds of Quantitative Easing following the great recession, the Federal Reserve allowed its balance sheet to rise to about $4.5 trillion by the end of 2014. The Quantitative Easing programs allowed the Fed to buy Treasury and Mortgage Backed Securities in an attempt to drive interest rates lower and keep them low. After the programs ended, the securities it purchased would mature over time. However, because of fears of unwanted interest rate increases at the time the last program expired, the Fed would purchase new securities to offset maturing securities. As a result, its balance sheet remained at approximately $4.5 trillion from late 2014 until late 2017.

Since the end of 2017, the Fed has been letting these securities "run off" by not replacing the maturing securities. The Fed has been managing the run off but such a run off will naturally put upward pressure on interest rates. As of the end of June 2018, the Fed's balance sheet has declined to about $4.3 trillion. The Fed's plan is to let its balance sheet decline to $3.0 trillion by 2020.

The 10-year U.S. Treasury Note yield began 2018 at 2.40%. It closed the second quarter at 2.85% after hitting a high in mid-May of 3.12%. Interest rates are certainly higher in 2018 and it is no coincidence that the rising rates corresponds to the Federal Reserve allowing its balance sheet to shrink. There is also expectation that GDP growth could accelerate which will put additional upward pressure on interest rates. As of June 29th, the Atlanta Fed forecasts GDP growth to be 3.8% for the second quarter 2018 (which it has ratcheted down from its previous forecast of 4.5%). Also, putting pressure on interest rates is a projected Federal budget deficit of close to a trillion dollars. Based on our Capital Market Outlook, we think the 10-year Treasury will finish the year close to 2.80%.

## *A Tale of Two Markets*

The bull market began in March 2009. The market turnaround was sparked by a rebound in corporate earnings following the financial crisis of 2008. But it was likely more impacted by the first Quantitative Easing program that started in November 2008 along with the near zero interest rate policy of the Fed. Perhaps coincidentally with the market turnaround, in March 2009 the Fed announced that it would expand its bond purchase program by nearly $1 trillion. The Fed liquidity fueled the equity markets. The fourth round of Quantitative Easing eventually ended in late 2014 and the near zero interest rate policy ended in December 2015. With liquidity drying up in 2015 and the anticipation of the end of the near zero interest rate policy, it is no surprise that the S&P 500 only returned 1.19% in 2015 (including dividend reinvestment).

Although we did not experience a “bear” market (a market that declines over 20% from its 52-week high) correction which would separate the 2009 through 2015 market with the current market that began in 2016, it is clear that the current market is being driven by different factors than the 2009 through 2015 market. Growth in corporate earnings have accelerated which is driving stock prices. The tax reform act of 2017 has resulted in a new source of liquidity. The market has continued to rise based on the anticipation of further benefits from the tax cuts. However, the market does face the aforementioned rising interest rates and Fed balance sheet reduction throwing caution to the wind.

## *Conclusion*

It has been a long time since we had an economic recession in this country and there are no signs of one on the horizon. Interest rates are on the rise and the Fed balance sheet is contracting. Inflation is peeking around the corner and should not be ignored. Corporate earnings are growing and tax cuts are seemingly stimulating the economy. Equities should continue to do well despite recent volatility while bonds will likely only return their coupon rates. Nonetheless, investors should maintain their long-term approach toward investing.

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