HighMark®
CAPITAL MANAGEMENT

Economic and Market Perspectives

2Q 2018

Introduction

The first quarter of 2018 began with the potential to continue a trend most equity investors could easily get used to. Strong returns and uncommonly low volatility fed intensely bullish sentiment that had been building over the prior five quarters. A fast start out of the gate for global equity markets had many contemplating a 'melt-up' scenario, where returns for an already rich equity market accelerate on the expectation that utopian conditions would prevail into the foreseeable future.

Such an optimistic outlook was supported by late-cycle domestic fiscal stimulus and accelerating economic activity internationally amid ongoing monetary stimulus in Japan and Europe. There seemed little reason to worry; the global economy stood at its strongest point since the end of the global financial crisis. A tone of positivity was common on corporate earnings calls that cited generous tax reform legislation as the core driver of earnings growth. With persistently low inflation confounding even the Federal Reserve ("Fed") governors, it appeared the paradigm that price increases would follow strengthening growth was broken and investors would get to 'have their cake and eat it too'.

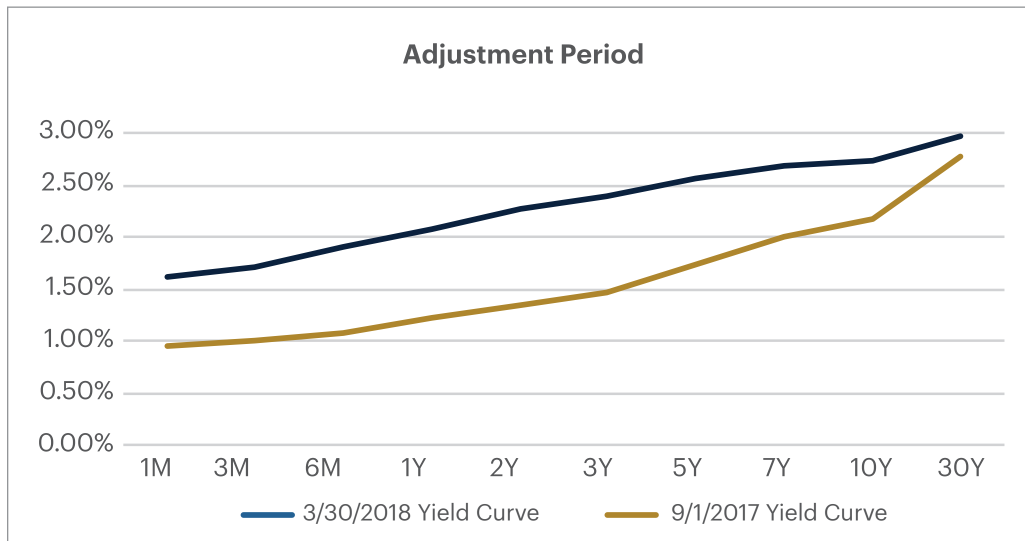
Unfortunately, the prevailing 'Goldilocks' narrative of accelerating global growth combined with tame inflation faced a challenge and capital markets did not stay calm for long.

Unfortunately, the prevailing 'Goldilocks' narrative of accelerating global growth combined with tame inflation faced a challenge and capital markets did not stay calm for long. In late January, investor worry began to percolate upward in tandem with interest rates once signs of accelerating inflation began to appear. By early February, the S&P 500 Index found itself in correction territory[1] with realized and future expected volatility spiking. Algorithmic trading programs appeared to fuel the fire during a period when one of the equity market's sources of demand, corporate buybacks, were limited during a blackout period.

Given the source of this concern, it was not surprising that bonds, which typically act as a safe haven during periods of equity market stress, did not hold up well either during the first quarter. The yield on the bellwether 10-year Treasury Note accelerated its upward trend, which began in early September of last year, during the first half of the first quarter peaking at 2.95%. With yields breaking out to the upside, some market prognosticators were even declaring the end of the 30-year secular bull market in bonds. Although the upward pressure on longer-term rates

[1] Commonly defined as a decline of greater than 10%.

subsided as the quarter closed out, the rally was not enough keep the broad U.S. investment grade benchmark (Bloomberg Barclays U.S. Aggregate Bond Index) from posting a loss (-1.5%) for the first time since the fourth quarter of 2016. The chart below illustrates the U.S. Treasury yield curve shift over the seven-month period through the end of the first quarter.



Source: Bloomberg

The equity market caught the second swing of a combination punch later in the quarter when President Trump made it clear he intended to follow through on the less market friendly aspects of his agenda, namely protectionist trade policy. By slapping tariffs on imported steel and aluminum, fears of a resulting broader trade war further clouded otherwise robust corporate earnings and economic data. Most observers believe the administration is seeking to obtain leverage in trade negotiations. However, an uncontrollable escalation is well within the realm of possibility once the protectionist genie leaves the bottle.

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At least for now, the anxiety permeating the equity market is not impacting credit markets. Investment grade and junk bond spreads relative to Treasuries were only modestly impacted during the quarter, signifying the bond market's disconfirming belief that the rising rate trend and trade policy turmoil are not likely to impair the trend of global economic stability in a significant way.

Economic Highlights

Fed Funds: Following a change in leadership, the Fed continued on its path of raising short term rates. In March, the Federal Open Market Committee ("FOMC") increased the Fed Funds rate by 0.25% for the fifth time since moving off the zero bound range to 1.50%–1.75%

U.S. Growth: Final fourth quarter GDP growth decelerated slightly to 2.9% after growing 3.2% during the third quarter. For the full year 2017, the domestic economy grew by 2.3%[2]—slightly above average for this expansion cycle.

[2] BEA.gov

Inflation: The Core Consumer Price Index, which excludes food and energy, accelerated to a nine year high of 3.1% annualized from December through February. However, many expect temporary factors pushing prices of certain goods and services higher will abate in the coming months.

Employment: The economy added an average of 202,000 jobs per month for the first three months of the year. This figure showed modest acceleration from the average 187,000 net new jobs per month created last year. The unemployment rate held steady at 4.1% as the labor force participation rate also climbed.[3]

Corporate Earnings: According to Factset,[4] the analyst consensus S&P 500 earnings growth estimate for the first quarter grew from 11.4% at the beginning of the quarter to 17.3% by the end of the quarter. Full year earnings growth estimates have increased by a similar amount as the impact of corporate tax reform is accounted for.

Consumer: The Conference Board's measure of consumer confidence hit an 18-year high in February and dipped only slightly in March as the impact of recent tax cuts began to show up in pay checks.

Housing: The S&P CoreLogic Case-Shiller U.S. 20-City Home Price Index continued to show strong gains despite rising mortgage rates. Through January the index appreciated 6.4% over the prior 12-months, finally surpassing the 2006 peak level.

Market Returns as of March 31, 2018

	% Total Return					
As of 3/31/2018	Q1 2018	YTD 2018	1-Year	3-Year	5-Year	10-Year
S&P 500	-0.8	-0.8	14.0	10.8	13.3	9.5
MSCI EAFE	-1.5	-1.5	14.8	5.6	6.5	2.7
MSCI Emerging Markets	1.4	1.4	24.9	8.8	5.0	3.0
Bloomberg Barclays U.S. Aggregate Bond	-1.5	-1.5	1.2	1.2	1.8	3.6
ICE BofA ML U.S. Treasury Bills	0.3	0.3	1.0	0.5	0.3	0.4
Bloomberg Commodity	-0.4	-0.4	3.7	-3.2	-8.3	-7.7

Source: Morningstar Direct
Periods greater than one year are annualized

[3] U.S. Bureau of Labor Statistics

[4] Factset Earning Insight March 29, 2018

Meet Jay

The Fed's rate hike in March was only the second most significant event during the first quarter from a monetary policy perspective. As closely as Fed Funds moves are followed, the more pressing question on the minds of Fed watchers is: "who is Jerome 'Jay' Powell and how will he lead the world's largest and most influential central bank?"

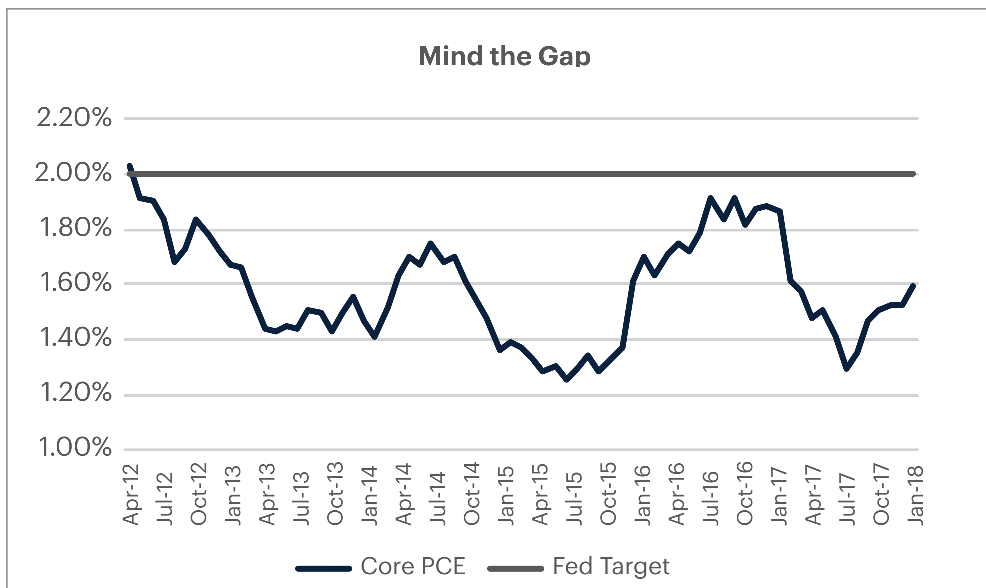
Nominated by President Trump to succeed Janet Yellen as Chair of the Federal Reserve, Powell inherited perhaps one of the most scrutinized jobs in the world. In February, he took the reins of a policy making body that influences nearly all aspects of the global economy in some way. While no stranger to the Fed (he's been on the Board of Governors since 2012), he is somewhat atypical in that he is not from an academic background as most of his predecessors have been. Powell began his career as a lawyer before moving on to positions in government and private equity.

By most accounts, the new Chairman is not predisposed to be overly hawkish or dovish. This quality will serve financial markets well by not allowing economic overheating or not choking off growth with an acceleration of the stated "gradual" path to normalization. Since markets hang on every word of a Fed Chair, investors will also appreciate his straightforward communication style.

As widely anticipated, in his first meeting as Chair, the FOMC raised rates by 0.25% for the fifth time since moving off the zero bound range in 2015.

We maintain a view that the change in leadership will not drive a material divergence from past Fed doctrine of being "data dependent". This was evident in Powell's initial testimony in front of Congress when he said "the FOMC will continue to strike a balance between avoiding an overheated economy and bringing PCE price inflation to 2% on a sustained basis." He might have also expressed a desire to avoid equity market overheating, as financial asset price appreciation has been a source of concern the Fed is keenly aware of, but far less vocal about.

As widely anticipated, in his first meeting as Chair, the FOMC raised rates by 0.25% for the fifth time since moving off the zero bound range in 2015. The Committee's dot plot indicated an additional two more hikes to come in 2018, yet some market observers are predicting a fourth hike will be executed before the year is over. While we are not inclined to agree with that point of view just yet, we do believe the market will not be significantly disrupted if the pace quickens modestly. Until signs of sustained price increases materialize, the Fed can afford to be patient. As the graph on the next page indicates, the Fed's preferred measure of inflation, the Core Personal Consumption Expenditure Index, has some ground to make up.



Source: Bloomberg

The March FOMC statement included a new line that stated "the economic outlook has strengthened in recent months," a nod to the likely impact of fiscal stimulus. However, this remark was balanced with an acknowledgement of concerns from "business contacts" about protectionist trade policy. To further complicate the monetary policy picture, the Fed must also mind the other end of the yield curve as it unwinds its balance sheet built up from three rounds of quantitative easing—or as some have described it, "quantitative tightening".

Powell enters the role of Fed Chairman as passage of tax reform creates a fiscal stimulus environment, allowing for future flexibility as the Fed moves away from its post-recession policies. Whatever the future holds, we expect him to be a pragmatic steward of the nation's monetary policy.

The Art of (Trade) War

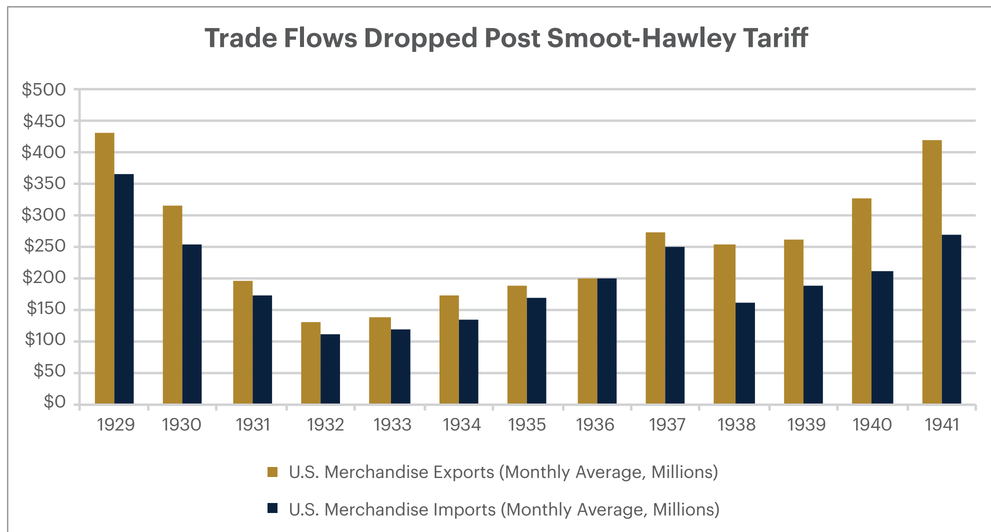
In recent weeks, President Trump has announced his intention to place import tariffs as high as 25% on imported steel and as much as $60 billion on specific imported Chinese goods. These China-targeted tariffs are in response to what the Trump administration has called years of unfair trading practices by China, including what the administration has deemed intellectual property theft. The announcements have stirred friction between the United States and China and have resulted in threats of retaliatory tariffs from China. This in turn has rattled global equity markets, with investors concerned about the potential for negative economic impacts and inflationary pressures from a potential trade war.

> *"My style of deal-making is quite simple and straightforward. I aim very high, and then I just keep pushing and pushing and pushing to get what I'm after."*
>
> *Donald J. Trump,*
> *Trump: The Art of the Deal*

On March 2nd, President Trump defended the most recent batch of tariffs via characteristic tweet, stating that "trade wars are good, and easy to win". However, past history has shown otherwise. No one wins in a trade war, and, in fact, previous history suggests mutually assured destruction with protectionist trade policies tending to trigger retaliatory policies from trading partners. This ultimately leads to slower global growth and higher-priced goods for consumers.

When the Smoot-Hawley Tariff Act ("Smoot-Hawley") was enacted in 1930, it was at first deemed a success, with production and payrolls increasing. However, it did not take long for negative effects to surface, among them souring relationships between the U.S. and its trading partners. As shown in the chart below, trade flows between the U.S. and trading partners declined sharply after Smoot-Hawley was enacted, by around 30% in the first year and continued to decline for two years thereafter. The impact was not isolated to the early 1930s. In fact, it took more than a decade to unwind these protectionist practices.

So far, President Trump has addressed four trade issues: steel and solar tariffs, the North American Free Trade Agreement ("NAFTA") and South Korea.



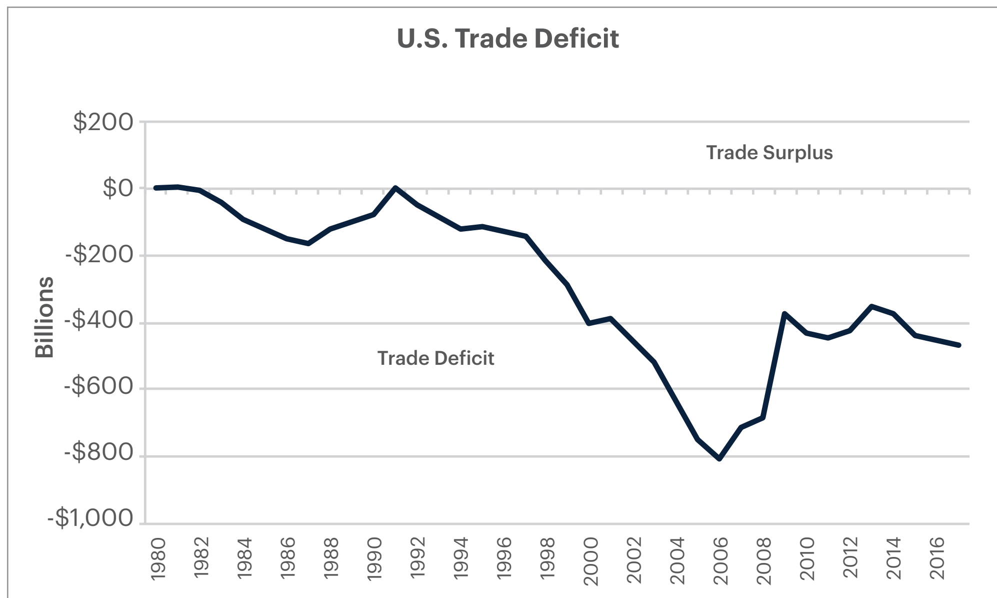
Source: Federal Reserve Bank of St. Louis (Economic Report of the President, 1965)

Given prior history, an important question emerges from the recent trade moves: do these changes represent a symbolic step with limited economic impact or has the U.S. embarked on a new confrontational policy path with unknown consequences? We believe that the most likely scenario ultimately will be one of negotiated compromises on a range of trade and intellectual property issues.

So far, President Trump has addressed four trade issues: steel and solar tariffs, the North American Free Trade Agreement ("NAFTA") and South Korea. In each of these situations, he started off with a big and aggressive proposal only to moderate it significantly throughout the negotiation process. His tone on NAFTA has significantly softened, with the U.S. exempting Mexico and Canada from steel and aluminum tariffs. He has renegotiated the bilateral trade agreement with South Korea. His first successful "deal," the revised agreement has further opened markets, broadening U.S. automaker access to South Korea's market, allowing for 50,000 vehicles per year to be exported, up from 25,000 prior to the renegotiation.

These "climb-downs" are signs of progress, and it appears likely that, overall, trade risk has peaked. While tensions and headline risk remain, serious escalation seems unlikely. In all likelihood, these tactics will lead to updated trade agreements within existing global trade frameworks, more protection for intellectual property, and corrections to global imbalances.

We believe that on balance, globalization and trade have lifted growth, incomes, and standards of living worldwide, while also reducing poverty. Overall, trade deficits are not as damaging as they are purported to be by populists on both sides of the aisle. While the U.S. ran persistent trade deficits in the 1990s and 2000s, we also enjoyed rapid growth in the economy and the stock market, along with low unemployment. Equally important, and often overlooked, is the Capital Account Surplus[5] we enjoy from having a trade deficit with our trading partners. This surplus reflects capital recycled back into U.S. markets, which drives expanded investment and lower interest rates. The graph below illustrates the U.S. trade deficit since 1980 as represented by the balance of payments data.



Source: Bureau of Economic Analysis

While there is no question that some industrial pockets, such as manufacturing in several states, have been negatively impacted and require attention, the plight of these segments has less to do with current trade policies and more to do with the widespread adoption of automation and its contribution to job displacement. While the hyperbolic rhetoric is popular in certain political circles, protectionist trade policies, unfortunately, will not be successful in bringing back these jobs.

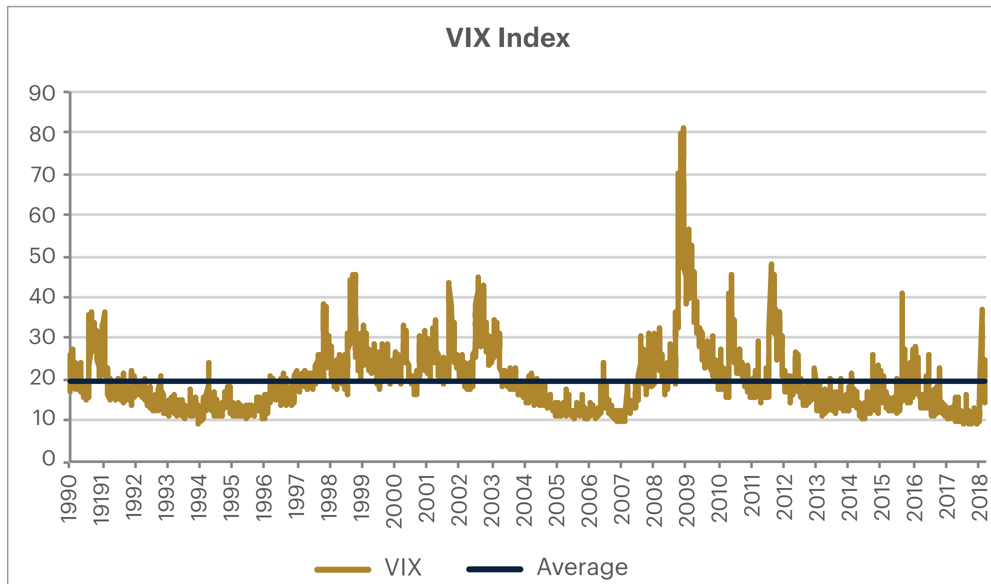
A more workable trade framework was always going to be needed given China's rising status as the U.S.'s main competitor. More confrontation will likely be the new normal going forward, a clear departure from the symbiotic relationship we shared in the past. We expect this evolving dynamic to add to investor hand-wringing and continued market volatility over the near-term. Ultimately, we believe that rational thought will prevail over political grandstanding, leading to a negotiated settlement that allows both sides to claim victory to their constituents.

[5] A Capital Account Surplus results from an imbalance in a nation's balance of payments capital account in which payments received by the country for selling domestic assets exceeds payments made by the country for purchasing foreign assets.

Back to the Future

The return of volatility to U.S. equity markets has many investors yearning for the environment of 2017, when volatility was well below its long-term average and equities rose seemingly without interruption. After such persistently low volatility and rising equity prices, it has been easy for market participants to be lulled into the belief that these trends would continue. Putting the recent return of equity market volatility into historical context, it is important to remember that 2017 was very much an atypical year for equity markets and volatility was abnormally low compared to past levels. The CBOE Volatility Index ("VIX"), which measures implied equity market volatility, has a long-term average of 20 as shown in the chart below.

We believe that the return of elevated volatility levels is really a return to a more typical investing environment and not the beginning of a bear market as some market watchers foreshadow.



Source: FactSet

In 2017, the VIX hovered well below its long-term level for most of the year. More recent measures ranging from the high teens to low 20s remain close to this long-term average and are not viewed as a sign for concern.

Additionally, volatility over more recent periods has moved in both directions (upward and downward) versus the unusual, one-way movements of 2017. We believe that the return of elevated volatility levels is really a return to a more typical investing environment and not the beginning of a bear market as some market watchers foreshadow. At the foundation of the equity market, the domestic economy stands in much better shape than in previous periods when volatility spiked; the labor market remains strong, and corporate earnings are in a position to grow at their fastest pace in years.

There are also some positives that have come with recent market activity. During the previous calendar year, equity valuations soared in tandem with rising equity prices. Market movements year-to-date have allowed valuations to normalize back to long-term averages and reset overbought and overly optimistic expectations to more undemanding levels. Greater volatility in markets can be good news for active investors because it may create inefficiencies and subsequent opportunities. These mis-pricings were harder to find in the prior era of artificially low interest rates and unconventional central bank polices that led to an atypical period of low volatility.

Conclusion

As investors incorporate rising uncertainty into the market pricing equation, increased volatility is the natural result. In many ways, the reining in of excessive risk taking due a greater appreciation for the inherently uncertain future is a healthy development in financial markets.

Although volatility and market drawdowns can be unsettling for investors, it is important to keep in mind that economic and corporate fundamentals remain strong and will act as a counterbalance to the fears of runaway interest rates and escalating trade tensions. However, a close eye must be kept on recent negative developments with regard to fundamentals, as both issues pose real threats to the status quo if either worsens.

As witnessed in the first quarter, market psychology can change instantly with very little warning. This once again reminds us all of the importance of staying committed to a diversified long-term investment strategy.

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