Titleist Asset Management

2018 Q1 Market Commentary

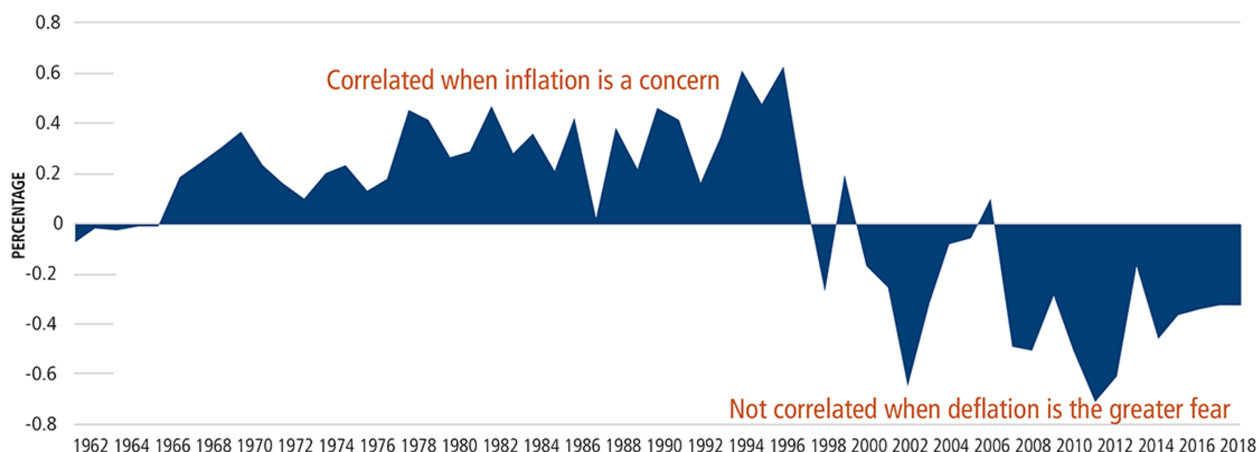
April 8, 2018 -

The S&P's first quarter win streak has finally come to an end after eight years. The S&P 500 closed out Q1 with a loss of -0.8% while the Dow Jones Industrial Average lost -1.9%. In general, indices with the highest concentration of large global companies fared worse as tariffs and trade rhetoric dominated the headlines. The S&P 400 mid-cap and Russell 2000 small cap indices closed out the quarter with losses of -0.8% and -0.1%.

Technology and Consumer Discretionary led the way with gains of 3.5% and 3.1% while more defensive sectors Consumer Staples and Telecom lost -7.1% and -7.5%. Rising interest rates throughout the quarter were a significant headwind for higher-yielding sectors in the equity market as they face more competition from fixed income.

International indices were mixed with the MSCI International Developed markets losing -2.04% while MSCI Emerging markets gained 1.62%. Emerging markets continue to offer the most growth at the cheapest valuation with earnings growth of 11.5% and forward earnings at 12.5x. Sector weightings in emerging markets have changed a lot over the past decade with Technology (27.1%) and Financial sectors (23.9%) replacing Energy (7.2%) and Materials (7.4%) with the highest concentration. *(Source: Morningstar Direct)*

The fixed income sector did not fare any better with the Barclay's Aggregate Bond Index losing -1.4% throughout the first three months of the year. Contrary to popular opinion, the inverse correlation between equities and fixed income over the past few decades may not continue should we enter into an inflationary period. This is not our base case but something that we will continue to monitor. The chart below illustrates the correlation between equities and fixed income throughout both inflationary and deflationary periods.



Source: Bloomberg, correlations of S&P 500 Index and 10-year U.S. Treasury yields x -1. Each graph point is the correlation for that specific year using daily data points.

S&P 500 Index is a market weighted index and is widely regarded as the standard for measuring U.S. stock market performance.

We are transitioning from a disinflationary – modest decreases in the inflation rate - environment to a slightly more inflationary world and markets are trying to figure that out. We do not think this rate hike cycle will look like the Greenspan era where the Federal Open Market Committee (FOMC) raised rates thirteen consecutive times from 2004 to 2006 *(Source: FOMC)*. Recent history shows there would be a lot

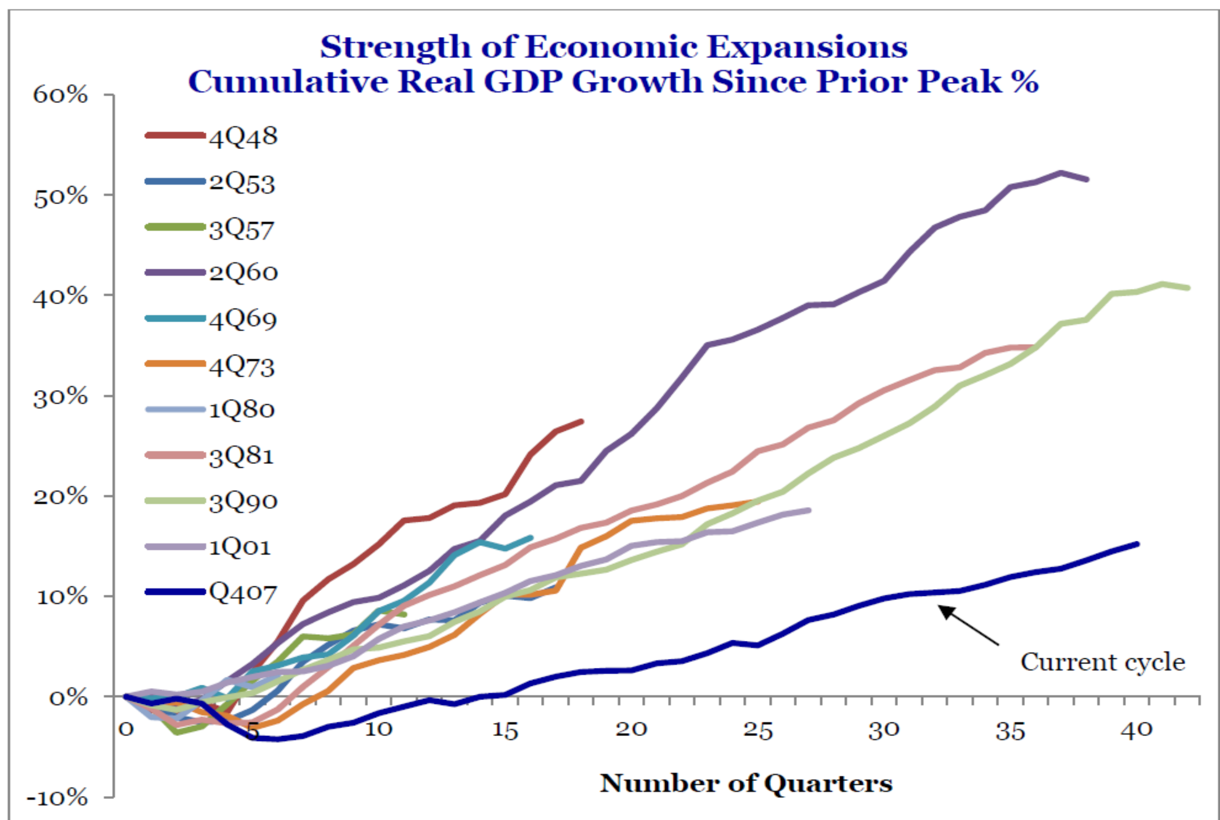
of wisdom in the Fed slowing down or pausing entirely while they wait for the full impact of previous rate hikes to play out. Fed fund futures are pricing in a 38.9% probability of three more rate hikes this year and 31.7% of four hikes. Our base case is that inflation remains near the Fed's mandate of 2% even though we are finally seeing improvement in real wages.

Even against the backdrop of higher inflation, bonds still serve a critical role in most portfolios. The chart below illustrates the difference between equities and fixed income going back to 1990 –

The equity market correction – defined as a loss of 10% or more – in February was the first since the 17% drawdown from Q2 15' through Q1 16'. The sell-off was sparked by inflation fears after the February wage report and was amplified by an algorithmic driven cascade of selling as VIX Short-Term Futures ETNs, generally known as a measure of "fear index" blew up while risk parity funds – strategies that are reliant upon an inverse correlation between treasuries and equities – were being unwound at extreme levels. The market soon recovered only to be blindsided by tariff announcements, tough trade rhetoric and fears over increased regulation in the technology sector.

After the record low volatility in 2017, it is important that investors remind themselves that corrections are entirely normal with the market averaging one sell-off of 10% or more every 13 months and the average sell-off coming in at 13.4%. We view the recent sell-off as a healthy development as it washes out weak hands and allows longer-term investors to enter the market at much more attractive levels.

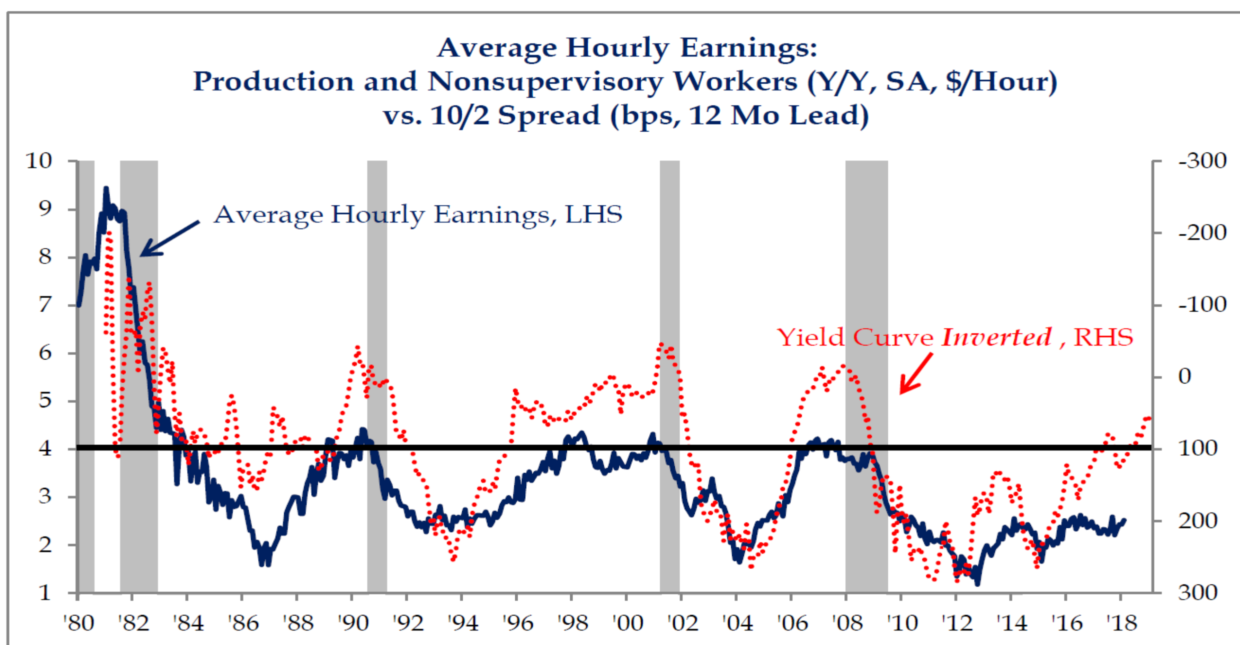
We are now nine years into the economic expansion, and most investors continue to question how much longer it can last. Even though we narrowly escaped National Bureau of Economic Research's (NBER) technical definition of a recession two years ago, the business cycle already had a recession with S&P profits declining from Q3 14' to Q4 15'. Even though this recovery has been long, the cumulative real GDP growth since the prior peak has been remarkably weak. This would suggest there is much more room to run just to match the average expansion. We originally introduced this data in our **Q2 2016 letter**. The chart below is another way of illustrating both the duration and weakness of the current recovery.



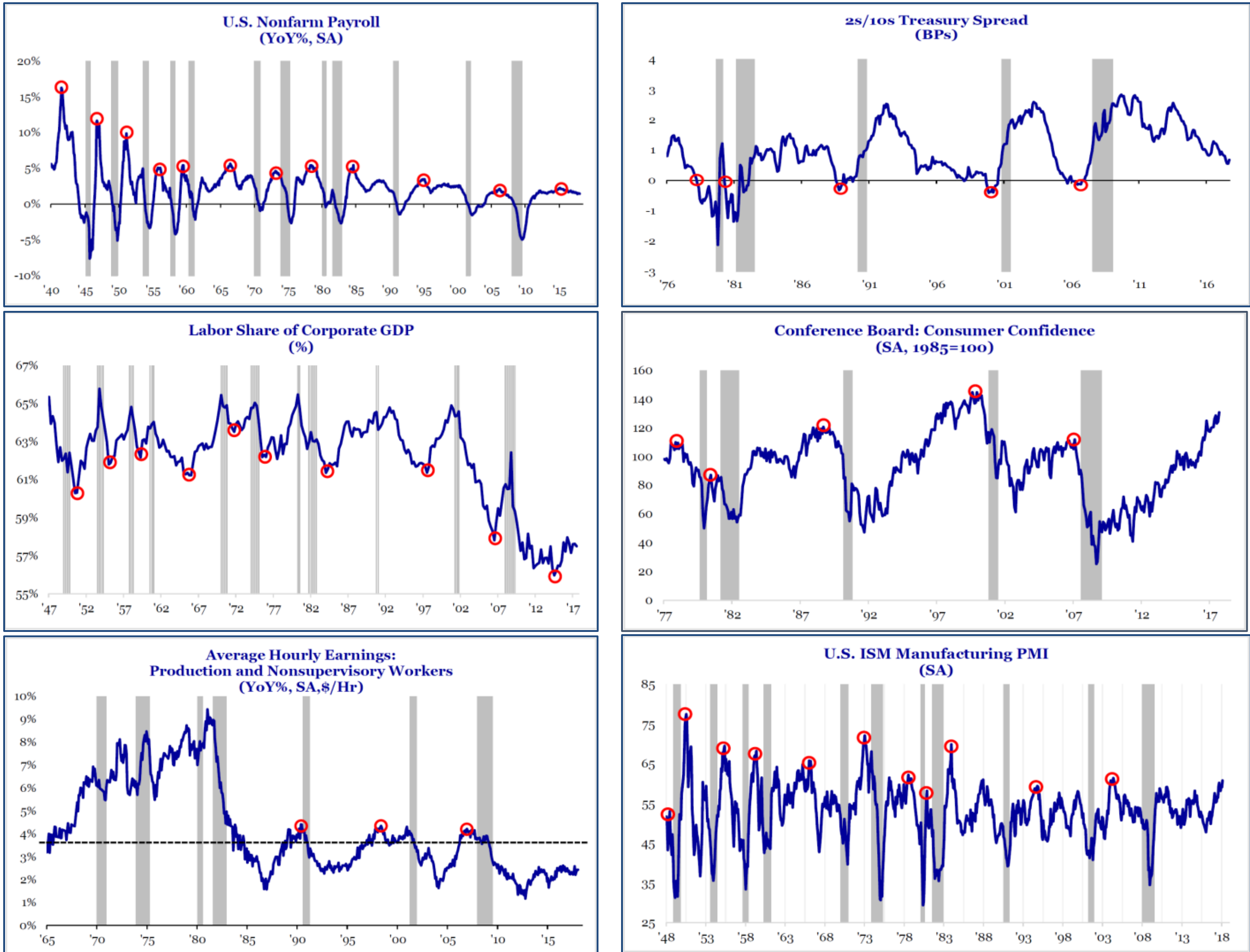
Source: NBER, Bureau of Economic Analysis

It has been so long since we have experienced sustainable economic growth that it's easy for investors to forget that things can be good for prolonged periods of time. Market drawdowns of 10% are normal but it's rare for equity markets to decline in excess of 20% unless there is a clear deterioration in economic output.

Recessions typically result from higher than anticipated inflation resulting in aggressive central bank action, policy errors or an unforeseen exogenous event. The chart below shows that today's 2.5% level of wage growth is a long way off from the 4% figure normally seen in advance of a recession –

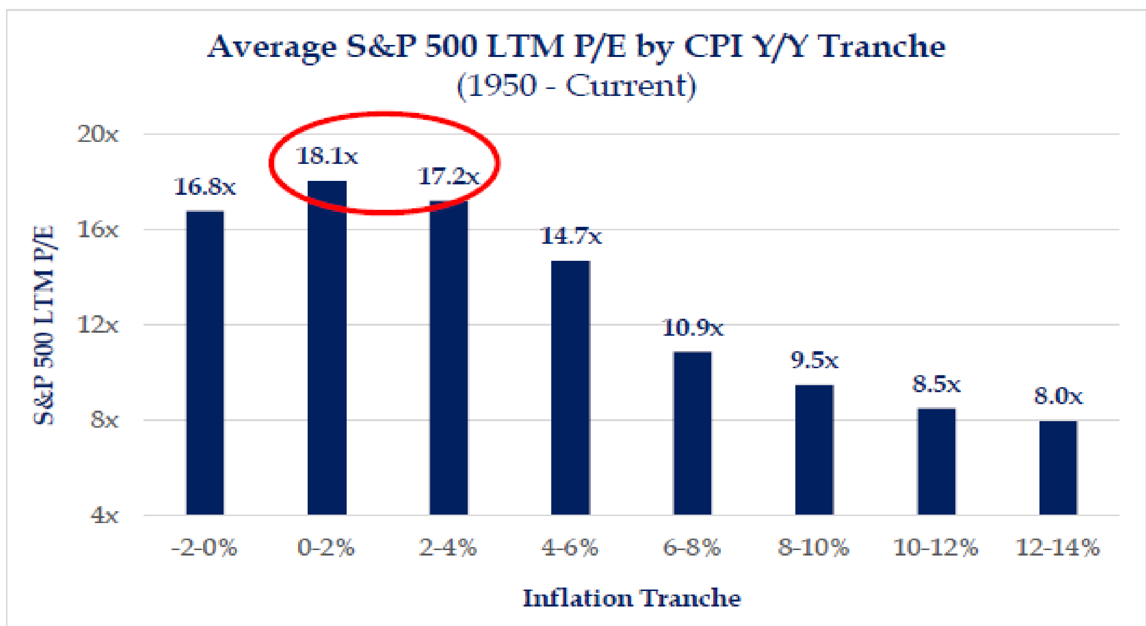


Economic fundamentals remain strong. Unemployment rates are near historic lows, labor force participation continues to improve and wages are finally starting to increase. Consumer Confidence, Manufacturing PMIs, US Employment Growth, Labor Share of GDP, Average Hourly earnings and US Yield Curve all suggest we have more time. The charts below detail the aforementioned indicators and provide some historical context –



Source: Strategas

Market fundamentals remain favorable. The market is trading closer to 16x forward earnings estimates, and that is well below historical averages when inflation and the 10-year treasury are trading at current levels. The chart below illustrates the average forward earnings multiple relative to various degrees of inflation. With inflation running close to 2% one could easily make the case that the market is trading at a slight discount to historical levels.



In summary, we think investors are underestimating the positive effects of fiscal stimulus and regulatory easing while overestimating the impact of potential trade wars. Absent a policy error out of the FOMC and/or White House, we continue to believe that economic and market conditions support a continuance of the expansion. Thank you for giving us the opportunity to manage your account.

- Byron Fields

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