Daniel WILDERMUTH™
MARKET COMMENTARY
March, 2018
- Presented by Wildermuth Asset Management

Economic Fundamentals Remain Strong Raising Inflation Concerns

By Daniel Wildermuth

After a tumultuous early February, which saw the S&P 500 decline over 10% from its previous highs, most global markets clawed their way back up to nearly even on the month before relinquishing some gains near month-end. Yet, despite the Dow Jones Industrial Average experiencing two 1,000-point declines during the second week of February, setting records for point losses, most global markets including the U.S. remain up for the year.

On a percentage basis, the losses were not extraordinarily large given past years of growth by the indexes that have pushed values up to levels almost unthinkable just a few years ago. Historically, double-digit percentage declines from market highs are quite common. During the S&P 500's tremendous runup since the financial crisis, which has more than quadrupled the index's value from its bottom of 666 in March of 2009, temporary losses have exceeded 10% five times and three of the declines exceeded 15%.

During the most recent 10% decline, the primary driver of the larger market volatility and losses appear to be "trader-induced volatility" kicked off by concerns over rich equity market valuations, increasing inflation, and the tightening labor market which could signal future inflation and possible growth constraints. The biggest trigger appeared to be January's inflation rate hitting 0.5%. The level was higher than expected, kicking off fears that we might drastically depart from the 2.1% inflation rate for 2017 that has been the norm for years. As real people reacted to news regarding fundamental indicators, their relatively mild moves activated computer trading algorithms. As computer trading moved markets, rapidly changing prices forced some firms and strategies to liquidate their highly leveraged strategies as the spreads between buys and sells widened, creating more turmoil. The result was panic-like conditions in options markets seemingly completely out of synch with economic fundamentals and relatively unspectacular news.

> *"Yet, despite the Dow Jones Industrial Average experiencing two 1,000-point declines during the second week of February, setting records for point losses, most global markets including the U.S. remain up for the year."*

Yet, while conditions may not be particularly worrisome, concerns over inflation and the sustainability of growth remain. On February 27th, Federal Reserve Chairman Jerome Powell's highly positive comments on the strength of the U.S. economy failed to instill confidence in investors, and instead his proclamations of good news prompted a sell-off, driving the S&P 500 down 1.27%. Most developed markets declined even more, and various emerging market indices were down nearly 3%. The "good news is bad news" dynamic results from investor fears that strong economic growth could fuel further inflation forcing the Fed to accelerate the pace of its interest-rate increases. The thinking continues that higher rates could then hinder economic growth while inflation ramps up – not an attractive combination.

How warranted are these concerns? Tight labor markets and wage inflation can reduce operating margins, and inflation appears to be ticking up. Yet, while inflation will likely to accelerate in 2018 from the historically low levels experienced since the financial recession, inflation's impact on the economy and overall impact tends to play out slowly according to history. Fears of this scenario seem to be driven more by the recognition that it could happen rather than an expectation that it will happen. In addition, the reappearance of inflation as a potential factor impacting the economy and markets is unsettling after its nearly complete absence for more than a decade.

Continued ...

While recent moves may have been uncomfortable for investors, reduced market prices and higher volatility levels are likely healthy for markets. Recent losses trimmed some of January's frothy gains, and lower market prices appear closer to sustainable levels. More normal volatility may also move markets closer to supportable prices as investors who may have grown overly comfortable with low volatility equity markets in 2017 either exit markets or adjust expectations.

Looking at more fundamental indicators, strong economic data continues globally. The developed world, especially Europe, is finally showing more robust growth, and emerging markets are also continuing to accelerate.

Within the U.S., forecasters see the economy continuing to strengthen this year. Economists surveyed in February by The Wall Street Journal predict U.S. GDP growth will hit 2.8% in 2018, accelerating from 2.5% growth in the fourth quarter of 2017. The year has started out well with various estimates calling for GDP growth better than 3% in first quarter.

Additional index readings suggest optimism and strong underlying economic activity. The widely followed University of Michigan consumer-sentiment index hit 99.9 in February, up from 95.7 in January, both high relative numbers. Economists' expected a measure of only 95.0. Despite recent volatility, only 6% of consumers negatively referenced stock prices in the latest survey. Somewhat surprising, 35% of consumers favorably referenced government policies in February, turning in the highest level in more than half a century. The Conference Board Leading Economic Index increased 1% to a very strong 108.1. Economists were expecting only a 0.7% rise. New housing under construction rose 9.7% from a month earlier, marking the third increase in four months. The number of building permits also rose 7.4% last month signaling more growth on the horizon. Corporate earnings continue to improve with 81% of companies in the S&P 500 beating earnings expectations with 80% of companies reporting – the highest level in eight years. Various forecasters also predict the unemployment rate will dip below 4% by midyear, down from 4.1% in January.

Despite the market turmoil, economic fundamentals remain sound and economists are optimistic. Leading indicators and corporate earnings trends point to a continuation of the economic expansion and bull market. No significant signs indicate that the economy is headed for recession or that earnings are poised to retract. Without either of these occurrences, a lasting bear market or even extended pullback seem unlikely.

Yet, danger can arise from many sources. Recent anxiety over sustainability of growth in the face of rising inflation appears to pose the largest nearer-term risk. The resulting economic constraints and more aggressive Federal Reserve actions could cause problems in multiple areas, trickling down into corporate earnings and equity prices. Hence, investors will likely continue to watch carefully for this painful combination, although it is not on the horizon at this time.

Today's environment is not necessarily bad for stocks, but it is possibly more complex. Equity valuations remain somewhat elevated even with the recent pullback in prices. Investors are likely wise to expect lower long-term returns and higher volatility, both typical of later stages of an economic expansion and equity bull markets. While circumstance do not appear to signal that gains are finished, more modest expectations, such as longer-term single digit annual returns, seem wise.

Wildermuth
ASSET MANAGEMENT

11525 Park Woods Circle | Alpharetta, GA 30005 | Ph. 678/506-3200 | www.WildermuthAsset.com