COUNTER | POINT

The Quarterly Commentary of Jurika, Mills & Keifer LLC

"Look, I'm not saying you're fired, Davis, but I might have just Tweeted it."

Mills

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Stormy Weather

After a strong and sunny start to the year, markets ran into a nasty patch of ***stormy*** weather in late January.

The storm clouds came suddenly, but not out of nowhere. Several of the factors that spooked investors like rising interest rates and inflation fears should not have been a complete surprise. The fact that the economy was doing well and that wages, prices and interest rates were climbing was known coming into the new year.

Geopolitical news such as the latest firing-by-tweet of a Cabinet member, turn of the

Summary:

- After a strong start to the year, markets ran into a nasty patch of stormy weather, ending the quarter mostly negative.
- Investors have a number of concerns including rising interest and inflation rates, trade wars, and geopolitcal instability.
- We think that most of these concerns are likely overstated. Meanwhile the world economy is still growing. Barring a meaningful deterioration in economic conditions, stocks should again move higher.
- That being said, we are in late stages of the current expansion, valuations are high and geopolitical risks are elevated.
- For these reasons, we continue to hold a more defensive allocation to risk assets.

Mueller investigation, alleged affairs and payoffs with porn stars and models, and open spats with domestic institutions, foreign leaders, celebrities and CEOs also should not have been a great surprise to anyone watching the news over the past year. The President's sweeping trade tariff proposals in March were more of a shock to the system, but consistent with his campaign rhetoric.

A few old adages about markets and investors come to mind: The first is that ***things don't matter until people decide that they do, and then they can matter a lot.*** A second one is that the ***markets have a way of confounding most of the people most of the time***. Put another way, markets tend to do the opposite of what most people – ***including experts*** - think they will.

We wrote in January that markets were long overdue for a pullback. Corrections and volatility are a normal occurrence. The ***lack*** of a correction and the lack of volatility is the thing that is not normal.

And so, towards the end of January, investors got spooked by a higher than expected rise in inflationary data and interest rates, decided that these things mattered, and started selling. And, contrary to the conventional wisdom that any dip in the market would be seen as a "buying opportunity," once the selling started, the "dip buyers" were nowhere to be found. Selling begot more selling, and markets fell.

The bellwether S&P 500, which was up as much as 7.5% in late January, ended the quarter down 0.8%. Within the U.S., technology and consumer discretionary were the only two sectors that produced positive returns. Outside the U.S., European and Japanese stocks also ended the quarter down 1.5%. Emerging markets did better, gaining 1.2%. Bonds fared worse than stocks, offering little shelter from the storm. The Barclay's Aggregate Bond index lost 1.5% and corporate and high yield bonds lost 2.9% and 0.9% respectively. [1]

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We have also written many times that corrections, while not especially fun, are actually healthy for markets because they disabuse investors of complacency and speculative animal spirits. There was a growing amount of complacency coming into the new year. Now, a healthy level of fear and skepticism has returned, which actually provides for more stable markets going forward.

Our present view is that most of the current investment concerns are overblown: more sound and fury than substance.

The fear in any correction is that it is the start of something worse. While it is true that all bear markets start with a correction, most corrections do not result in bear markets. Major market declines have historically coincided with recessions and there is nothing in the economic data that suggests that a recession is imminent.

The global economic backdrop remains strong. Economies around the world are still growing, but there are signs that the *rate* of growth is declining, suggesting that we are in the later stages of the growth cycle. The kind of volatility we have recently seen in the markets is typical of this phase of the economic cycle and while it can be disquieting for investors, it is not typically indicative of deeper problems.

There is always the possibility of an event from left field such as an escalating trade war, or a military conflict throwing economies into the lurch, but otherwise, we think the current global expansion still has some room to grow. If so, we would also expect global stock markets once again to move higher, perhaps even in a final "blow-off" phase, before the economic cycle finally reverses and the next recession begins, most likely in another one to two years.

But investing is not a risk-free proposition and there is the potential that near-term dysfunction and political self-interest may trump rational long-term economic and political interests. Markets crave certainty and stability and most of the recent tweets and pronouncements from the Trump administration have only fostered uncertainty and instability. Keep your seat belts fastened.

Here is our take on some of the current concerns affecting investors and markets:

Inflation and Interest rates: Inflation and interest rates are rising, while economic growth is slowing, creating a fear of stagflation. While we see some inflationary pressures in prices and wages, they remain contained and there is still considerable excess capacity in the U.S. and around the world. Interest rates are still low by any historical standard and not high enough to prevent sensible projects from being financed or to stall the economy.

Economic Growth: While the rate of growth in the global economy appears to be slowing, economies are still growing around the world. In the U.S., the additional boost of fiscal stimulus from the new tax bill is just starting to work its way through the economy and should add up to an extra 1% to GDP this year and next. There is also the possibility of an infrastructure bill that would provide an additional boost to economic growth, but also add to inflationary pressures within the economy.

Trade War: The President's initial announcements of Tariffs against imported steel and metals were a shock to most businesses and governments, including our own. The administration has subsequently backed off on most of the original provisions and started to focus on China, the main culprit in dumping metals and stealing intellectual property. Meanwhile, China has just announced a set of its own tariffs, primarily targeted at U.S. agricultural products, many of which just happen to come from regions that voted for Trump. We think most of this posturing will give way to more reasoned negotiations and minimal economic impact.

With respect to China, it is important to note U.S. exports to China amount to less than 1% of U.S. GDP.[2], most of which is comprised of agricultural goods. Meanwhile, if China dumps its holdings of U.S. Treasuries, that would just weaken the dollar and make U.S. goods more competitive. A trade war with China or any other country is ill advised, but since imports account for only 15% of U.S. GDP, it will likely hurt others more than it does us.

Geopolitical Risks: We normally think it is wise not to mix politics and investing. The global economy is large, diverse and has a momentum to it that tends to transcend the short-term political events and even presidencies. But recent political and geopolitical events reflect a higher than normal level of uncertainty and risk to the world economy and investment scenario. The rise of populism at home and abroad threatens the foundation upon which a lot of current global commerce and cooperation is based.

Here in the U.S., all of the blustering and posturing about trade as well as attacks on companies like Amazon, undermine the very economic growth that the tax-cuts were designed to stimulate. In addition, the growing lack of breadth and depth of competent staffing within the White House and throughout the government is destabilizing. It puts the government in a reactive rather than strategic mode and increases the risk of major economic, social, diplomatic and military missteps.

Meanwhile around the globe, long-standing relationships and treaties are under attack, and former allies are questioning the U.S.'s role as a reliable counter party. China, Russia and other actors are happily stepping into the void. We do not know how things will evolve, but a world without clear leadership, where every country is looking after itself, is a less stable world and a higher level of risk that should be factored into investment decision-making.

Investment Strategy:

As long as the global economic backdrop remains strong, we think the current corrective phase in the markets will run its course and markets will eventually head higher before marking the peak for the current economic cycle.

That being said, we do think we are in the late innings of the current cycle and as such, the risks are higher. Market valuation levels are generally full or even expensive, and more sensitive to negative surprises and disappointments. We think the economy will continue to chug along and companies may impress investors with how well they are doing. Some will also use repatriated cash and higher profits to buy back stock and increase dividends, adding additional support to their stock prices.

Expected returns from this point forward should be lower than the historical average and given all the unknowns – *both knowable and unknowable to quote Donald Rumsfeld* – we continue to think it is time to invest more cautiously, with a more conservative allocation to risk-oriented assets.

We trimmed equity exposure last fall as we felt the potential returns relative to risks were growing less favorable. In hindsight we were four months too early but now have a cushion of defensive investments that we can redeploy back into stocks or other areas when we see a compelling opportunity for investment.

Over the long-term we continue to invest with a global focus, balancing investments targeted at areas of long-term growth and innovation, such as technology, life sciences and the developing world, with more defensive equity, alternative and fixed income strategies aimed at mitigating volatility and risk.

As always, we welcome your comments, questions and referrals.

Jurika, Mills & Keifer, LLC
April 2018

Notes:

[1] Source: Bloomberg

[2] Source: BCA Research

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Private Wealth Management

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Our firm is built on a core set of values and investment principles that have been central to our identity and success for over 30 years.

Our objective is to preserve and build the purchasing power of our clients' capital over time through forward-looking investment management and smart financial planning and counsel.

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