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Quarterly Commentary

After rising more than 8% in the first few weeks of January, the S&P 500 fell roughly 9% through the end of Q1 leaving the index down almost 1% year-to-date. What just happened?

We believe a normal and healthy correction occurred driven by fear, uncertainty and investors' desires to take profits after a long stretch of investment gains. Passive investing is now such a large part of daily trading activity that investment flows into and out of ETFs may have led to increased volatility. Volatility was also exacerbated by headline-grabbing developments including deficit and inflation, tariff threats, ongoing investigations, administration turnover and geopolitical concerns. For now, much of the turmoil is more theoretical than real, but the uncertainty persists. However, the only sure thing is the very positive late December tax cuts which will significantly boost earnings beginning in 2018.

Combined with very strong economic fundamentals including job growth, wage gains and high levels of manufacturing activity, we believe that the equity markets are poised to rise through the balance of 2018. There may continue to be some equity weakness in the near term until investors once again begin to climb their wall of worry, but we remain confident that the main drivers of equity performance – earnings, interest rates and valuation – all remain reasonably favorable for equities while continuing to pose risks for fixed income. Our main concern remains a larger than expected increase in inflation but for now, with the 10-year bond well below 3%, we don't see this as an imminent threat.

The Trump trade tariffs and unorthodox trade negotiations involving both NAFTA and China are understandably currently creating uncertainties for investors. An optimistic view is to suggest that President Trump is picking the right fight with respect to China. It is only a matter of time (10-20 years) before China is the undisputed global economic leader. To argue that China should start to live within the same international trade rules as the rest of the developed world is in both the US and Europe's best interests. However, if not handled in a reasonable way, these trade disputes could turn messy and be a drag on global equity performance.

Finally, let's go back and review what our new Chief Economic Advisor, Larry Kudlow, calls the mother's milk of stocks: earnings. S&P 500 earnings estimates for 2018 began to rise during 2017 based on higher economic growth estimates for 2018. 2018 estimates at Argus Research were originally expected to grow almost 10% to the mid $140s range and now, post the tax cut legislation, are slated to grow almost 20% y/y and to approach $160 for 2018. Estimates for 2019 are expected to grow an additional 10% and may reach as high as $179. A market multiple of 18x on these estimates would put the S&P 500 above 3200 or up almost 24% from current levels.

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