

Back on a Wilder Ride

Which is to say that despite the record absence of stock market volatility over the last couple of years, the erratic behavior displayed this past quarter is a poignant reminder of the “risk” associated with equity markets! Lest we forget, investor expectations have always been tied to the age old axiom of risk versus reward, a notion as old as Methuselah himself, our favorite “Old Testament” character who lived some 969 years!

Looking back on the first quarter, January extended 2017’s already outsized returns by another 6-7% before the equity markets decided it was time to inject a dose of reality, including a short-lived “correction” into the mix. This led the major US bourses into flat or negative territory by quarter’s end: with each of the S&P 500, the Dow and the Nasdaq posting total returns of (1.6%), (2.4%) and +1.1%, respectively.

We think the underlying factors that triggered the market’s surprise Q1 volatility were “technically driven” and not due to any material change in equity fundamentals. In fact, those fundamentals are well entrenched both in the US and across the world as the global economic engine continues to hum in sync. Rather, the perpetrators of the very pronounced price swings were North Korea’s saber rattling and our counter rattling, President Trump’s declaration to impose trade tariffs and the nascent fear that global trade wars might result, and most recently, the disclosure by Facebook and Cambridge Analytica of personal privacy breaches which led to Congressional hearings.

Meanwhile, as we examined the quarter’s nominal stock performance by capitalization and style, we noted that small caps generally edged out mid and large caps return, while growth maintained its edge over value style investing during the period.

On the matter of inflation, interest rates and the bond markets, it was pretty much more of the same. We simply remain on this long road to a “higher cost of money”, something we should remember as a “normalization process” following years of crisis-driven ultra-low rates. The recent 10 year TIPs breakeven rate suggests that inflation has, at least for the moment, modestly moved ahead of the Fed’s 2% target at 2.18%, its highest level since August 2014. Notwithstanding that inflation seems to remain stubbornly quiescent, the Fed opted once again to raise its overnight lending rate on March 21st with near certainty for more to come by year end. That said, the anomaly is that short rates have backed up more quickly than intermediate (10 year) and long dated Treasury yields prompting concern over a so-called flattening yield



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curve, which historically is said to portend recession. We find it hard to believe that any recession is in the offing unless a trade war materializes to trigger a slowdown in global commerce. On that note, our sense is that the bluster of hard line tariff talk will eventually subside into reasonable and hopefully fruitful negotiations for all trade partners.

Meanwhile, there's an ever growing preoccupation as to when the 10 year Treasury yield will breach its 3% threshold. With rates having been so low for so long, we understand the psychology (some would call it angst) behind the focus. But at the end of the day, this threshold is arbitrary and irrelevant since breaking it proffers both benefits and costs for the wider economy.

So against this backdrop of nominal monetary tightening, how did bonds fare? Not surprisingly, like equities, the bond markets posted modestly negative returns during the period. The Barclay's 10 Year Municipal index registered (1.6%), while the taxable Barclay Aggregate posted (1.5%) and the Barclay's High Yield Index recorded (.86%).

Moving on, let us offer a few last comments on the broad energy sector and midstream oil and gas MLP's in particular, since both continue to lag well behind general market returns. Frankly, lackluster performance over the past 15 months has us puzzled since the macroeconomic picture appears so bright. Thanks to strong global growth, Brent and West Texas Crude Oil futures prices have risen steadily for more than a year and seem to have stabilized between \$63-70/bbl at this writing. Oil inventory overhang, which has persisted for several years, has nearly evaporated, moving us ever closer to supply /demand equilibrium. Shale technologies have catapulted US oil production to historic levels, now some 9.2 million bbls/day with projections for over 10 mil bbls/day by 2020, all while dramatically lowering production costs. Such production momentum points to the need for additional infrastructure. It is estimated that over \$165 billion in new pipelines and storage facilities will be needed to keep pace with oil flows under what is now a very accommodating federal administration. Notwithstanding that there are credible peripheral headwinds currently in play, including the question of self-discipline by shale drillers and generally rising interest rates and shifting business models for MLPs, we continue to believe these sectors are woefully undervalued and that they will eventually breakout to the upside.