Market and economic outlook

Brinker Capital

March 2018

Market volatility came roaring back in February with the VIX Index surging to levels last seen in 2015 and washing out signs of complacency that were present earlier in the year. Risk assets fell sharply in response to macroeconomic data that was considered too positive; a strong jobs report and an uptick in average hourly earnings sparked fears of inflation. Markets recovered quickly but ended the month below the level they started. As we progress through 2018, we expect solid fundamentals will continue to support risk assets but we expect higher volatility than we saw last year.

The S&P 500 Index finished the month down -3.7% and is up 1.8% year-to-date. All sectors, excluding information technology, posted negative returns for the month. Energy (-10.8%) experienced the largest drawdown due in part to a rise in oil inventories adversely affecting prices. Yield proxy sectors, telecom (-7.1%) and utilities (-3.9%), which typically have more defensive characteristics, also came under pressure as interest rates moved higher throughout the month. Information technology (0.1%) was the only sector to eke out a small gain. Growth led value for the month and large-cap outperformed both mid-cap and small-cap equities.

Developed international equities were down -4.5%, underperforming domestic equities for the month. The European Central Bank and Bank of Japan maintained their dovish stance as inflation within the regions remained below stated targets. The dispersion among global yields will likely increase as the Eurozone and Japan continue to implement easing monetary policies while the Federal Reserve (Fed) is in the middle of a tightening cycle, with at least three additional rate hikes expected this year. Similar to developed international equity markets, emerging markets was down -4.6% for the month. A stronger dollar and commodity weakness served as headwinds to the region. Moving forward, the implementation of protectionist US trade policies may heighten tensions between the US and exporting emerging markets countries, leading to more volatility in the region.

The Bloomberg Barclays US Aggregate Index was down -1.0% for the month with all sectors posting negative returns. Interest rates continued to climb, with 10-year Treasury yields increasing 15 basis points, ending the month at 2.9%. Credit spreads widened slightly, generating negative returns for both investment grade and high yield securities, but remain at tight levels relative to historical values. Municipals outperformed taxable counterparts but were also negative for the month.

We remain positive on risk assets over the intermediate-term, although we acknowledge we are in the later innings of the bull market and the second half of the business cycle. While this cycle has been longer in duration compared to history, the recovery we have experienced has been muted, supported by the extended recovery period. While our macro outlook is biased in favor of the positives, the risks must not be ignored.

We find a number of factors supportive of the economy and markets over the near-term.

- **Pro-growth policies of the Administration:** The Trump administration has delivered a new tax plan and a more benign regulatory environment. We could see additional government spending on infrastructure in 2018.
- **Synchronized global economic growth:** Growth in the US has started to accelerate, and growth in both developed international and emerging economies has meaningfully improved. The tax cuts could also help to boost GDP growth in 2018.

- **Improvement in earnings growth:** Corporate earnings growth has improved globally and corporate tax reform should further benefit US-based companies.
- **Elevated business sentiment:** Measures like CEO Confidence and NFIB Small Business Optimism are at elevated levels. This typically leads to additional project spending and hiring, which should boost growth. The corporate tax cut should also benefit business confidence and lead to increase capital spending.

However, risks facing the economy and markets remain, including:

- **Fed tightening:** The Fed will continue to tighten monetary policy, with at least three interest rate hikes priced in for 2018. We may see tightening from other global central banks as well.
- **Higher inflation:** Current levels of inflation are muted but inflation expectations have ticked higher and the reflationary policies of the Administration could further boost levels. Should inflation move higher, the Fed may shift to a more aggressive tightening stance.
- **Geopolitical risks:** Geopolitical risks including protectionist trade policies and global challenges could cause short-term market volatility.

Despite the volatility experienced recently, the technical backdrop of the market remains favorable, even more so as some of the complacency has been removed, credit conditions are still supportive, and global economic growth is accelerating. So far President Trump's policies are being seen as pro-growth, and business and consumer confidence are elevated. The onset of new policies under the Trump administration and actions of central banks may lead to higher volatility, but our view on risk assets remains positive over the intermediate-term. Higher volatility can lead to attractive pockets of opportunity we can take advantage of as active managers.

Brinker Capital Barometer (as of 1/5/18)

Factors		Negative	Neutral	Positive	Commentary
Short-term factors (<6 months)	Momentum			●	Continued strong momentum and decent breadth
	Trend			●	Global markets above 50-day and 200-day moving averages
	Investor sentiment	●			Survey readings in excessive optimism territory
	Seasonality			●	First quarter historically positive for global equities
Intermediate-term factors (6-36 months)	Fiscal policy			●	Fiscal stimulus - tax bill and potential for infrastructure
	Monetary policy		●		Fed tightening; ECB and BOJ still modestly accommodative
	Inflation			●	Below Fed's target, but some evidence of global reflation
	Interest rate environment			●	Longer-term rates low; curve flattening but positive
	Macroeconomic			●	GDP growth accelerating; labor, housing, PMIs positive
	Business sentiment			●	CEO and small business confidence at high levels
	Consumer sentiment			●	Elevated; potential to move higher due to tax cuts
	Corporate earnings			●	Global earnings advancing
	Credit environment			●	Favorable; credit spreads have continued to grind lower
Long-term factors (36+ months)	Valuation		●		Valuations elevated, but could remain as earnings improve
	Business cycle			●	Second half of cycle; long recovery but has been muted
	Demographics		●		Mixed (US and EM positive; DM negative)

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