HALLMARK CAPITAL MANAGEMENT, INC. | Integrity Professionalism Responsiveness

Economic and Market Newsletter
Spring 2018

Hallmark Capital Management, Inc.
1195 Hamburg Turnpike
Wayne, New Jersey 07470
973-808-4144
www.hallcapmgt.com

VOLATILITY REAPPEARS . . .

Our last quarterly letter focused on the unusually low level of stock market volatility in 2017. We noted that volatility was likely to increase, but our timing turned out to be better than we knew. Almost immediately after our letter was sent, the serene calmness that had pervaded in the stock market for the past eighteen months was disrupted. Traders who were short the CBOE volatility index were "disrupted" in about the same way as the ancient Romans were "disrupted" when Attila the Hun knocked at the gates of the city. The Standard and Poor's 500 Index was up over 5% in January, then dropped a full 10% in value in the first ten days of February. The index then ground higher for a few weeks and was able to recover much of its earlier losses. Just when it appeared that the storm might be over, there was a sharp 6% sell-off during the last week of trading, followed by a one-day rally to end the quarter. According to Ned Davis Research, 2018 has already seen 25 trading days when the S&P 500 Index was up or down more than 1%, compared to only 8 such days in all of last year.

Despite all the turmoil, the S&P 500 Index was very little changed at the end of March from where it opened the year. In fact, anyone not focused on the day-to-day moves in the market might be forgiven for assuming that it has been a relatively unexciting quarter! It is worth noting, however, that even at the low point, the S&P 500 Index had only pulled back to the levels of last November. If the market had peaked then and remained relatively flat in the ensuing months, we suspect that few investors would have been surprised or upset. Given human nature, however, how one arrives at a point tends to be just as important as where one lands.

. . .WITH SAFETY LAST?

The internal discrepancy between the leap in volatility and the relative underperformance of many traditionally defensive asset classes last quarter was curious. One might have presumed that the sharp downward moves in the stock market would have pushed investors toward safe havens. The S&P 500 Index generated a small loss in the quarter, but it still managed to outperform most intermediate and long-term bond indexes. Higher risk investments, such as emerging market stocks, commodities and high P/E growth stocks outperformed the S&P 500 Index, but higher yielding and low beta stocks generally lagged. Bond investors and stock investors seemed to focus on completely different issues in the quarter.

Bond prices reacted to the one-two punch of higher-than-expected wage growth reported in the January employment report, followed by an unexpectedly sharp increase of 0.5% in the January Consumer Price Index. With both wages and prices moving higher, the odds of Chairman Powell and his colleagues raising the Fed Funds rate three or four times this year increased. Consequently, two-year U.S. Treasury Notes traded at their highest yield and lowest price since the Financial Crisis, back in 2008. Ten-year Treasury prices were slightly less sensitive to potential increases in short-term rates, but they also reacted, pushing yields back to levels last seen in 2014. With two-year Treasury prices falling more than the ten-year, the difference in yields between the two narrowed, flattening the yield curve. Many view a narrower 2-10 spread as an early indicator of an imminent economic slowdown, which should have sent investors toward the shares of recession-resistant companies.

The best sectors in the stock market, however, were two groups highly sensitive to economic growth … technology and consumer cyclicals. The tech-heavy NASDAQ Index outperformed both the S&P 500 Index and the Dow, despite the negative political fallout concerning Broadcom, Facebook and Amazon. The Russell 1000 Growth Index closed <u>up</u> *1.4%* for the quarter while the Value Index <u>dropped</u> *2.8%* during the same period. The rise in bond yields hurt the shares of many interest-sensitive companies, which heavily impacted the finance-heavy Value Index. This is not what one would normally expect with a choppy market, but is consistent with equity investors remaining optimistic about future profit growth.

THE MARKETS ARE BEING PULLED BY DIFFERING OPINIONS ON THE ECONOMY

On the surface, the consensus outlook for economic growth and inflation hasn't changed very much over the past year: steady as she goes. The turbulent swings that were seen in the stock market this quarter are indicative that investors are either less certain of their forecasts, or that the range of potential outcomes has broadened. Even though there is broad agreement on real GDP growth of 2.5% this year, there are vastly different assessments of the economy's health. One side sees an extremely fragile environment, with economic growth totally dependent on easy global monetary conditions and massive Federal spending. They fear that the Federal Reserve, in attempting to normalize monetary policy, will raise short-term rates beyond the point that a frail U.S. economy can stand. While they believe the Trump tax cut will boost growth in the short-term, they see the affect as similar to offering a second helping of ice cream and cake at a child's birthday party. Activity may pick up in the short-term, but it will fade quickly once the sugar wears off. They also believe that any benefit from the tax cut could be offset by the threat of rising tariffs and trade restrictions.

Others see the same backdrop, but find a generally vigorous economy. They point to an unemployment rate near all-time lows, synchronized global growth spurring demand here, and modest rates of inflation. They believe higher short-term rates are more than justified by the low jobless rate and improving profit outlook. Rather than fear an overshoot in monetary policy, they see the Fed's moves as validating their optimism. For them, tax cuts are no sugar high, but are only one step in a series of productivity-enhancing moves, including cutting regulations and changing unfair trade rules. Which side ultimately wins the argument could have considerably different implications for future sector performance within the stock market. A few weeks do not make a trend, but we are searching for subtle changes in leadership in this period of high volatility to see if we can determine which theory is right.

ANALYZING THE TEA LEAVES

During times of high volatility, there can be a rotation to a new favored sector, destined to lead the market for an extended period. As it is occurring, this transition is usually not as smooth or as clear as it is in hindsight. After a serious drop, investors often tend to first flock back to the former winners, which instantly seem cheap. This group will snap back quickly and make it look as if the existing trend is still in place. We have seen this already: the glamour technology stocks were often snatched up with each market reversal early in February, but then were the hardest hit sector when the market cracked in March. We cannot say for certain that the long-term technology trend has broken, however, since the technology sector continues to lead the market on a year-to-date basis.

Also, no clear-cut winner has yet emerged to take technology's place after it peaked relative to the market on March 12. Electric utilities did fine, but telephone utilities did not. Energy did relatively well on some days, but not others. Widely divergent groups, such as industrials, health care, basic materials and finance all performed roughly the same. If the optimists are right and economic growth is poised to accelerate, we should see the more economically sensitive groups begin to outperform. Under those circumstances, we would also anticipate that the stock market would broaden so that its performance would be less dependent on the movements of a relative handful of stocks. If the more defensive groups move to the lead, that would indicate the economic slowdown is likely to be greater than most now expect.

CHANGES IN VOLATILITY ARE NOT PREDICTIVE

With all the turbulence, more clients than normal have expressed some concerns about the markets. After last year's long stretch of low volatility, it is not surprising that this bout of market choppiness is unnerving. It is important to note, however, that a return to a more volatile market environment is not, by itself, a harbinger of an imminent bear market. A perfect example is what happened in 1996. After a very strong year in 1995, when the stock market returned over 37%, there were signs that the economy was slowing in response to higher interest rates. Christmas sales in 1995 were disappointing and some of the manufacturing and employment reports started to deteriorate. Corporate earnings announcements in January were mixed. The stock market started to fall in February and the broad indexes sank by over 10% by June. Things looked pretty gloomy. Then, that summer, every major economic indicator flipped from deteriorating to advancing. After a poor first half, the stock market was up almost 26% in the second half, leading to over a 22% total return for the year.

WE ARE NOT IGNORING RISKS, HOWEVER

According to figures provided by Ned Davis Research, since 1900, mid-term election years ***without recessions*** have suffered average stock market declines of over 15% at some point during the year. Fiscal policy may be highly stimulative, but the policy makers of the Federal Reserve are on a path of reducing liquidity and normalizing interest rates. Central bankers can no longer be counted on to rush to the rescue during a market drawdown. Also, the concentration of investor focus on large capitalization growth companies creates a situation where the overall markets have become highly sensitive to the performance of a relative handful of stocks. There are plenty of risks out there.

In recent trading days, the root cause of the stock market's volatility has been easy to discern … whenever the market believes the Trump Administration's threats of a trade war, stocks decline. When investors sense that the tough talk is simply a negotiating ploy, markets rally. Under normal circumstances politics is hard to predict, but it seems even more so recently. This is the point where we all need to step gingerly. Perhaps all the harsh rhetoric really is a strategy to set up more serious negotiations with China. Certainly, the U.S. would be better off if the Chinese were to change some of its more egregious trade policies. It is also true that each side of the trade conflict could feel boxed in by the posturing and forced to take mutually disruptive steps. Ultimately, we believe that no one, politicians included, have a professional death wish. While we acknowledge the potential downside of an all-out trade war, attempting to put an appropriate risk premium on it is extraordinarily difficult. We certainly would not feel comfortable basing our asset mix decisions solely on this issue.