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MARKET OUTLOOK
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The US stock market this year has been a tug-of-war between improving corporate earnings and investors' decision to pay less for them. So far, the contest is a draw.

BY THE BOOK

Seldom will you see a more stark and dramatic illustration of how stocks are priced than we had in January and February of this year. Stocks exploded out of the gate in January, rocketing up 6% for the month. Then, just as violently, the market plunged 9% in the first six trading days of February, wiping out the previous gains and putting the S&P 500 index marginally in the red for the year. Which is where it ended the quarter, showing a slight negative return of 0.76% for the period. And, so, the market—weirdly—ended up having both its *best* January and its *worst* first quarter in eight years.

Welcome to the new volatility, which ended a two-year stretch of very calm and climbing markets. While this volatility was unwelcome, it was the two-year calm before it that was unusual. In January, the US stock market set a record for the number of trading days (395) it had gone without a 5% pullback from recent highs. We said in our January Market Outlook that such a pullback was overdue and, in fact, would be welcome to cool the market's animal spirits.

Despite the drama, the market's behavior strikes us as entirely rational as it illustrated the textbook factors that drive stock prices. The market's 6% rise in January matched Wall Street analysts' 6% upward revision to their estimates of S&P 500 earnings (profits) for 2018. This revision was largely due to the corporate tax cuts enacted by Congress in December. Cutting corporate taxes increases corporate after-tax earnings. All else equal, if S&P earnings estimates rise 6%, so should its stock prices.

So, why did stock prices then fall 9%? The other factor that drives stock prices besides earnings is the price investors are willing to pay for them (the price-to-earnings or P/E ratio). Stocks' 6% rise in January reflected rising estimates for corporate earnings. The 9% decline in February reflected a decline in the price investors were willing to pay for them.

INFLATION FEARS

This decline was prompted by a report on the employment picture in the US for January, which showed wages growing at the fastest clip since the Great Recession. Obviously, there's nothing wrong with wage growth *per se*. But overheating wage growth is often a harbinger of a more general overheating of inflation. And keeping inflation from overheating is, in part, what the Federal Reserve was created to do.

The Fed does this by raising short-term interest rates and thereby the cost of borrowing. Raise these rates enough and the economy will slow, which in turn cools inflation. An unfortunate byproduct of this process is that corporate earnings slow and the stock market goes into a decline. As we've said many times, bull markets in stocks don't die of old age. They're killed by the Federal Reserve working to quell inflation.

January's wage growth was the first foreshadowing of a process that ***eventually*** could threaten corporate earnings growth and thereby rising stock prices. Investors responded by paying less for a stream of future earnings that suddenly seemed shorter. Does this mean the end is near for rising stock prices?

CORRECTION OR BEAR MARKET?

As I write these comments the market is in the throes of a "correction," meaning a decline in stock prices that exceeds 10%. At its nadir, the current pullback took stock prices down 12% from their late January peak. It's worth noting that this is the first correction the market has suffered in two years. Historically, the market "corrects" about once a year on average. So, again, we had a long calm spell and got used to it.

The question, of course, is whether this correction will turn into something more lasting and painful. Generally, a bear market in stocks—a decline of 20% or more—occurs as the market begins to discount a future recession. Typically, this happens when the Federal

Reserve is raising rates to quell inflation, which has been sparked by an overheating economy, the first sign of which is often overheating wage inflation.

Currently, the Fed is NOT raising rates to quell inflation. As explained last quarter, the Fed is raising rates despite inflation being BELOW its desired target of 2% (the most recent inflation reading was 1.7%). The Fed is raising rates to normalize monetary policy after the unusual measures taken in the wake of the Great Recession. Chief among those measures was holding the short-term Fed Funds rate near 0% for seven years. The Fed is keen to raise this key rate because being able to *lower* it is the Fed's best tool for combatting weakness in the economy.

With inflation below the Fed's preferred 2% level, the economy has room to heat up more before the Fed starts to worry. Indeed, inflation below 2% is itself seen as a worrisome sign of potential *deflation* to the Fed, a worry the Fed has had since the Great Recession. The most recent reports out of the Fed indicate that inflation a bit above the 2% target could be tolerated to insure the risks of deflation are reduced. So, at this point, we're not worried about the Fed being overzealous and tipping the economy into recession.

We also noted last quarter that the tax legislation passed by Congress in the fourth quarter of last year will act as a booster shot of stimulus for the economy--by leaving more dollars in consumers' and corporations' pockets and by providing tax incentives for corporations to spend on capital equipment. This should extend the current economic expansion and push the prospect of recession well into the future. Our best estimate is that a recession in the US is very unlikely until at least 2020, which is well beyond the stock market's current scope of concern.

TRADE WARS

Thus far, we've discussed the stock market and business cycle in terms of the economic fundamentals that generally determine their ebb and flow. As everyone knows, there is another factor, a wild card, if you will, that must be considered. And that is the threat of a US trade war with China.

From well before he became a candidate, much less president, President Trump has railed against what he sees as unfair trade practices by China. Lately, he has issued a series of trade policy threats--tariffs on foreign imports--aimed at correcting what he sees as the primary manifestation of China's unfair trade practices, namely, the trade deficit the US runs with China.

While there is no question that China has long engaged in unfair trade practices, one of the very few things that Republicans and Democrats agree on today is that a trade war with China is not the way to correct them. A tit-for-tat spiral of trade tariffs between the US and China would severely harm both countries' economies.

We hope the Trump Administration understands this and is bluffing to gain advantage in more nuanced negotiations with China. But as has become abundantly evident, handicapping President Trump's true intentions is a tall order. Which is why the markets are gyrating so wildly of late.

TUG OF WAR

The defining dynamic in the US stock market this year has been a tug-of-war between rising earnings estimates and falling P/E ratios. That is, while the earnings picture is improving, investors are willing to pay less for those earnings than they were only a couple months ago. So far, the contest is a draw.

The falling P/E ratios reflect both incipient inflation risk and heightened geopolitical risk. Absent the geopolitical risk, we think the improving earnings picture would carry the day. Which leaves us, as it does most investors, in the uncomfortable position of waiting to see how our mercurial President deals with China. Absent a self-inflicted trade wound to the US economy, we think markets have further to run.

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