TOWNELEY CAPITAL MANAGEMENT

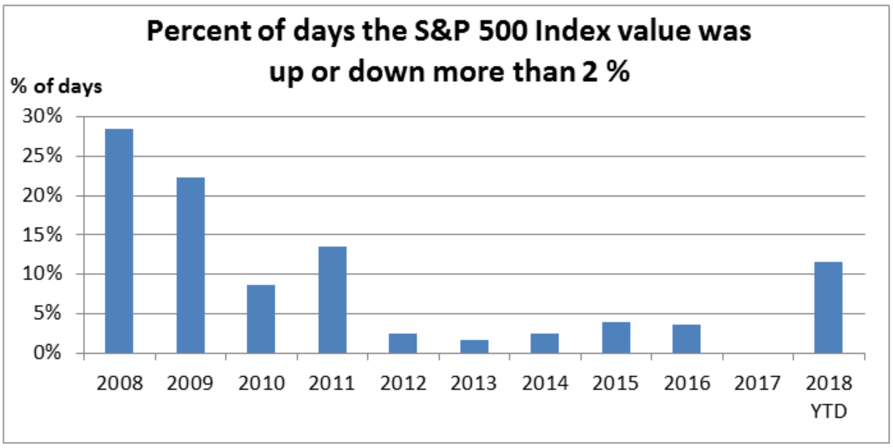
The latest news and updates for the first quarter of 2018

As 2018 dawned, it seemed we might settle in for another year of records in the equities markets. After all, 2017 brought us headlines like "The Dow Just Set a Record for Setting Records" (MarketWatch, December 19, 2017), and the S&P 500 gained 7.6% for the year-to-date period ending January 26. However, over the next two weeks, it dropped 10.1% before turning positive again. By the end of the quarter, the index was down only -0.8%. Thus, midwinter's briefly plummeting prices caught a welcome updraft before the quarter came to an end.

In this newsletter, we will take a closer look at stock values and their relationship to market volatility, which all but disappeared last year. The prospect of trade wars triggers investor uncertainty, contributing to volatility, so we will investigate that phenomenon, as well. Finally, we will wrap up with a review of the strategic changes we have implemented in your portfolios to keep you well-positioned for the current economic climate.

Of Values and Volatility

When we talk about equities being expensive or overvalued, the price-to-earnings ratio (P/E ratio), or more often, the cyclically-adjusted price-to-earnings ratio (CAPE ratio) are factors underlying the valuation*. In 2017, stock prices rose more than earnings. This outcome increased the P/E ratio, leading to the judgment that stocks are expensive. This year, however, earnings are rising while stock prices remain relatively flat. Thus, equities are still expensive but becoming less overvalued as the P/E ratio decreases. Some of 2017's stellar equities performance probably resulted from investors anticipating higher earnings in 2018 and buying up stocks, thus making them more expensive. A low return in 2018, therefore, would not be such a bad thing, as earnings will go up and the P/E ratio should decline, making stocks a better value.



Based on a volatility gauge using daily values of the S&P 500 Index, volatility levels in 2017 were lower than we have seen in over 50 years. The first three months of 2018 brought increased volatility, however, as levels are now above the mean. In 2017, the S&P 500 lost more than 1% on only four days, and it never dipped below 2%. Already in 2018, the index has dropped over 1% on 13 days; seven of those days brought declines of more than 2%. Between 2012 – 2017, the average number of days each year where the index was down over 2% was only three days. The last time the index dropped more than 2% on more than six days was back in 2011. In 2008, the index lost over 2% on 41 days.

These wide market swings demonstrate that volatility may be more common in an expensive market. When equities are costly, it does not take much for investors to overreact. Imagine the stock market as a simple pendulum. Its string represents stock values–the more overvalued the prices, the longer the pendulum's string. Negative news provides the nudge that sets the pendulum in motion. The longer the string, the bigger the arc when that pendulum moves. If the market were cheap, our pendulum's string would be shorter, and it would display a smaller arc after a media "nudge."

The return of big daily market moves can cloud one's judgment and challenge one's resolve to stick with long-term goals. We anticipate a continued higher level of volatility, compared to previous years. However, economic fundamentals remain strong, the likelihood of a U.S. recession is still low, and economists anticipate increasing U.S. corporate earnings. Regardless of the size of the "pendulum's" swing, it will eventually come to rest, as prices are mean-reverting.

* For an in-depth discussion of P/E and CAPE ratios, please click on "Are Equity Markets Overvalued?" by Towneley's director of research, Shu-Chin Li.

Trade War

The trade war has taken center stage this year as the Trump administration has announced tariffs on various goods, notably steel and aluminum. If the U.S. implements tariffs, other countries may retaliate with tariffs of their own. Historically, in this circumstance, U.S. companies have either absorbed the higher cost or passed it on to consumers via higher prices, and we would expect the same result this time around. When companies raise prices to cover tariffs, the increase does not benefit the company or the consumer; in fact, the increase may feed inflation. However, neither lower profits nor higher inflation is good for the stock market or consumer.

Currently, our trading partners are requesting exemptions to the tariffs, while our government officials contemplate negotiated quotas for exempted nations. Many countries have received exemptions, as China is the principal target of this policy. China, in turn, has announced new tariffs on U.S. goods. A trade war will probably be averted via satisfactory agreements with China and other nations, but we expect the stock market to remain volatile until the matter is resolved.

Your Portfolio

Between December 2016 and January 31, 2018, cumulative gains for the Standard & Poor's 500 were 28.8%, and for the MSCI EAFE Index, cumulative gains came to 31.3%. When the equity portion does well and grows, it surpasses the objective we have established, in consultation with you, for your portfolio. This situation signals that your assets may be exposed to more risk than is appropriate for your portfolio. As the markets have become more volatile and expensive, in February of this year we rebalanced portfolios back to their target objectives to take gains and help reduce equity risk in client portfolios. We accomplished this goal by selling equities and buying fixed income.

Within the fixed income asset class, we have also made strategic changes. The Federal Reserve began increasing the Fed Funds rate in December of 2015 and has since increased it six times. As the Fed Funds rate has increased, other short-term interest rates have increased as well. Both the 6-month U.S. Treasury and the 2-year U.S. Treasury yields have gained 1.5% over that period. However, longer-term interest rates have remained relatively flat, edging up only slightly. The yield on the 10-year U.S. Treasury was 2.3% in 2015 and had gained only 0.6% by February 28. Thus, we see that the spread (the difference between the long-term and short-term rates) has been decreasing as short-term rates have risen and longer-term rates have stayed relatively flat. Shorter-term bond prices are generally less susceptible to interest rate risk than are long-term bonds, so as the short-term bond yield approaches that of long-term bonds, short-term bonds become more attractive. With the intention of reducing the interest rate risk in your portfolio, we recently increased short-term bond exposure and decreased intermediate (longer duration) bond exposure. The resulting shorter average duration should help reduce interest rate risk in the fixed income portion of your portfolio as interest rates rise.