



Part 1: STOCK MARKET CORRECTION:

What happened, what it means, and what to do

Part 2: BONDS, RATES & INFLATION:

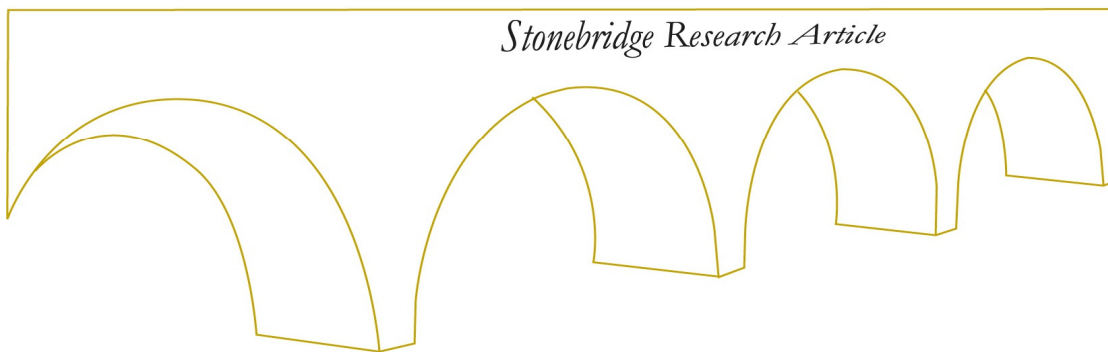
What is happening, what it means, and what to do

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The Bridge

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Part 1: STOCK MARKET CORRECTION

What happened?

Concern that rising wages will spur inflation and push the Federal Reserve to raise interest rates faster than forecasted gained significant strength after the Feb. 2 strong jobs report sent bond yields soaring and equities plunging into the first correction in two years.

Since Jan. 26, investors have been reacting to an assortment of economic signals: the CBOE volatility, inflation data, employment gains, wage increases and U.S. Treasury yields. The sharp equity sell-off has occurred amid concerns that a rise in interest rates will eventually stall economic growth.

Stocks have been on a wild ride with the Dow Jones Industrial Average dropping 10.4% from its peak on Jan. 26 of 26,616 to 23,860 on Feb. 8, a drop of 2,756 points in 9 trading sessions. At one point, on an intraday basis Feb. 9, the Dow fell to 23,360 - a drop totaling 3,256 points or 12%. As of Friday, Feb. 23, the Dow had recovered more than half of those losses closing at 25,709, but is still down 907 points (3.5%) .

The S&P 500, a broader measure of the stock market than just the 30 stocks of the Dow Jones Industrial Average, responded in kind, dropping 140 points or 5% from 2,872 on Jan. 26 to 2,779 on Feb. 23. The speed and severity of the plunge was painful, particularly compared with the previous year and a half in which the index never fell more than 3% from a previous high. With the S&P 500 index experiencing the longest run in its history without a 3-5% pull back and over 2 years since full 10% correction, the recent events were not totally unexpected. Reality is that we have moved into a more mature phase of this recovery cycle—both in terms of the economy and the markets.

What does this mean?

Major economies around the world are growing in tandem for the first time since the Great Recession and corporate profits continue to rise and surprise. This combination usually carries stocks higher. The recent correction has been just that, a correction, and we do not believe it is the end of this bull market run. With low unemployment, gross domestic product growing at a healthy pace and fourth-quarter S&P 500 earnings rising at a double-digit pace, we do not see signs of an economic slowdown on the horizon – yet. Strong global growth and corporate earnings did not just suddenly vanish on Jan. 26. Indeed, according to FactSet, of the approximately 400 companies in the S&P 500 that have reported Q4 earnings results thus far in February, 75% have beat on profits and 78% beat sales estimates. U.S. employers are hiring at a healthy pace with unemployment at a 17-year low of 4.1%. The housing industry is solid and manufacturing is rebounding.

What to do now?

We believe the recent market correction has provided an opportunity to buy select companies at more attractive entry points. That being said, we are mindful of where we are in the current cycle and select companies that are top performers in their respective industries with strong balance sheets. We are steadfast in our belief that diversification among sectors is critical to long term investment success.

In addition, make sure clients' asset allocation is appropriate for their risk profile, individual goals and stage of life. Periods of market volatility can be a wake-up call to review your risk tolerances, making sure your portfolio is adequately diversified. For additional stability, we believe investors should consider adding defensive assets such as an increase in cash or fixed income securities. Remember, a 20% - 40% combined allocation of cash and bonds still provides 60%-80% of exposure to the stock market.



Part 2: BONDS, RATES & INFLATION

What is going on?

We are coming to the end of quantitative easing. For the last ten years major central banks around the world have been buying up bonds to stimulate economic activity and hold down interest rates. Now they are starting to reduce and unwind their balance sheets. In the U.S., the Federal Reserve has raised rates five times since December of 2015. Market participants believe the Fed may need to be even more aggressive - hiking rates further and faster than expected. Finally transitioning from the unprecedented monetary policy over the last 10 years, the Fed is in the process of simultaneously engineering interest rate hikes and balance sheet reductions. Although recent fiscal policy is seen as a growth driver, it is also likely to be inflationary. Since last fall, the benchmark 10-year treasury yield has risen about 85 basis points from 2% to 2.85%, which is a big increase in a short period of time — but not the end of the world.

What does this mean?

We believe the economic narrative is beginning to change.

Increased inflation expectations have been driven up by strong economic growth and low unemployment causing wages to rise; these factors alone should push up demand which in turn leads to higher prices. Also, the dollar is down about 12% this year which tends to push up import prices that will eventually make their way into inflation calculations.

The budget deficit is likely to rise over the next couple years due to recent legislation efforts on infrastructure spending and the Republican Tax Cuts. As a result, the U.S. may need to issue more bonds, and when they do, they will need to find somebody to buy the bonds.

History has shown when bond supply increases, yields need to rise to attract more buyers.

No one really knows what a bond bear market would look like today, largely because yields have been on a downtrend in the U.S. for more than 30 years. Higher rates are already in play across the entire Treasury yield curve and the yield on Treasuries maturing in two years is at the highest level in almost a decade. As bond math works, bond values decrease as interest rates increase. During a rising rate environment, longer-term bonds are most sensitive to potential losses, which is when an investment manager's specific bond strategy weighs heavily in performance.

What to do?

Stonebridge portfolios favor well selected municipal and corporate credits with attractive spreads to U.S. Treasuries. Treasuries are the closest investment available to a risk-free asset because of an assumption that the U.S. will not default on its obligations. Treasury investors who ignore market fluctuations and hold their bonds to maturity are expected to receive their money back in addition to interest payments. Investment grade municipal and corporate bonds, although not as safe as U. S. Treasury bonds, generally offer greater income while providing a similar level of principal return at maturity.

We continue to recommend shorter duration high quality municipal and corporate bonds with predictable cash flows and an emphasis on liquidity. We strive to take advantage of inefficiencies in the yield curve that provide more attractive yields and income. These opportunities may include lower rated credits if our in-house research staff deems the security to be creditworthy and appropriate for a given client portfolio.



Conclusion

As stated above, the recent correction has been just that, a correction and we do not believe it is the end of this bull market run. Be cautious but thorough in your security selection and diligent when assessing personal risk tolerance. Add bonds of shorter duration to seek stability, liquidity and principal preservation. As these bonds mature, reinvestment of the principal at potentially higher interest rates will provide an increased income and cash flow.

Source

Performance sourced from Bloomberg

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