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First Quarter 2018

Volatility With a Vengeance

Where do we begin when attempting to describe the events in the market and global economy in the wild first quarter of 2018? The markets were off to a roaring start to begin the year with both the Dow and S&P 500 hitting record highs yet again, mainly driven by a weaker US Dollar, strong corporate earnings and the tailwind of the tax bill. However, as the calendar turned from January to February volatility came bursting onto the scene like a bull in a china shop. The second week of February stocks experienced their worst weekly decline since 2008 on the fear of rising inflation and potentially higher interest rates. The Dow and S&P 500 officially fell into correction territory, each declining more than 10% from their previous highs. The CBOE Volatility Index (VIX), commonly referred to as the "fear gauge" on Wall Street, spiked over 170% in the first three trading days in February. After hovering throughout all of 2017 at record lows not seen since pre-2008 crisis levels, the volatility index skyrocketed to its highest level in over two years. Those who thought volatility was a thing of the past were served a rude awakening.

As the dust settled from the swift correction in early February, the markets gradually recouped some of their losses over the following weeks. Yet volatility appeared again in late March following the news of tariffs that the Trump administration planned to impose on steel, aluminum, and China in particular. Furthermore, tech stocks finally showed cracks in the armor with the admission by Facebook that roughly 50 million U.S. users' personal info was given to Cambridge Analytica, a data analytics firm who allegedly used that data for campaign research. In addition, Trump seemed to single out Amazon and other large tech companies for anti-competitive practices and big tech companies became susceptible to the same volatility the general market had experienced.

The S&P 500 tested key technical levels, closing just above its 200 day moving average on March 23 before recovering and ending the quarter down -1.22%. The Dow Jones Industrial Average snapped a nine-quarter winning streak and closed out the quarter down -2.49%. The NASDAQ never officially corrected and ended positive for the quarter, up 2.32%. International markets rightfully reacted poorly to the tariff news and the MSCI EAFE was down -2.37% in Q1. In the fixed income markets, the fear of inflation and worries about an overly aggressive Fed caused rates to increase. The 10-year Treasury rate spiked by over half of a percent (50 basis points) by mid-February before retreating slightly and finishing the quarter at 2.74%, 34 basis points higher than at the start of the year. The Barclays US Bond Aggregate Index was down -1.46% in Q1.

As we begin to see volatility not-so-subtly arrive back in the markets, it is understandable for many to question whether or not this economic expansion still has legs to get us through 2018 without falling into the next recession. While the majority of market indexes were down for the quarter, it is important to take a step back and look at the current expansion through a rational lens rather than gauging it solely based on market performance and emotion. As we have noted in the past, the current expansion is the third longest expansion in post-WWII history and is on pace to be the second longest after April 2018. If the current expansion lasts through June 2019 it will be the longest on record. That being said, it has also been one of the slowest expansions in post-WWII history. That is mainly because the U.S. economy has shifted over the years from an industrial-based economy to a service-based economy. If you look at recessions from several decades ago the main cause was inventory control. Companies would all of a sudden have an excess of inventory due to a drop in demand, shut down production and lay off workers. Those workers would then decrease their spending and slow their consumption which would send a ripple effect throughout the rest of the economy. That does not tend to be the case anymore.

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Growth in service industries has made the economy more stable, which has led to fewer recessions. That is a big factor in analyzing the current environment we are in. While this expansion is certainly long in the tooth, it is important to understand that expansions do not die of old age. That is not to say that long expansions aren't more vulnerable, as they do become more susceptible to external factors. Most likely there will be a catalyst that is going to send the economy into a recession, whether that be an asset bubble bursting, a severe geopolitical event, a trade war, or even something the market hasn't thought of yet. On the other hand, it is also important to take into account the amount of stimulus that has been implemented throughout the duration of this expansion, including the most recent fiscal stimulus via tax reform and an increase in the budget deficit (while that sounds counterintuitive, government spending is a boost for GDP growth). These actions should reduce the probability of a recession in the near-term as both corporate earnings and consumption remain strong as the tax cuts put money directly back into the hands of taxpayers.

Tax Law Changes for 529 College Savings Plans

The recent federal tax overhaul made withdrawals from 529 College Savings Plans for payment of up to $10,000 of K-12 tuition income tax free. This can provide a tax planning strategy, especially for parents or grandparents in states that provide income tax deductions for contributions to 529 plans. However, not every state conforms to the federal rules. Depending upon the state, withdrawals from 529 accounts could result in state income taxes being due for the investment gains and potentially repayment for any state tax deductions or credits received at the time the 529 contributions were made. Kansas and Missouri do conform to the federal rules so it is currently allowable to pay private K-12 tuition from the 529 accounts while obtaining income tax deductions on your Kansas and Missouri returns. We encourage you to discuss this strategy with your advisor.

It is easy to forget what "normal" volatility is after the anomaly that we experienced in 2017 with regards to volatility. For instance, in 2017 the markets saw zero 5% drawdowns and only eight 1% daily moves. The historical averages for the S&P 500 are four 5% drawdowns and upwards of 50 1% daily moves in a single year. So far in 2018 we have seen three 5% down moves and 22 1% daily moves in the market. The VIX was below a level of 10 for 50 days in 2017—well above the historical average—and has only spent seven days below 10 year-to-date in 2018. The market hadn't experienced a 10% correction in almost two years prior to February.

2018 Performance Figures

	1st Qtr	2018
DJIA (Dow)	(2.49%)	(2.49%)
S&P 500	(1.22%)	(1.22%)
NASDAQ COMP	2.32%	2.32%
MSCI EAFE	(2.37%)	(2.37%)
Russell 2000 Small Cap	(0.40%)	(0.40%)
Barclays US Aggregate Bond Index	(1.46%)	(1.46%)
MSCI World All Cap	(1.80%)	(1.80%)

It's not difficult to become short minded when it comes to the markets in this era of the 24 hour news cycle. When we see big fluctuations in the equity markets like what we've seen in the first quarter of 2018 the natural response is to question the stability of the economy when in reality there are still many positive factors to consider. The reality is that the global economy is currently experiencing as strong of growth as we have seen in the past decade and the probability of a recession is lower than what the volatility appears to be telling us. In fact, volatility is "normal" and the lack of volatility we experienced in 2017 is "abnormal!"

As geopolitical issues and potential trade wars dominate the headlines, we expect the recent level of increased volatility to continue. The market is struggling to reconcile the idea that economic growth is strong, but that same economic strength could lead to higher inflation and therefore higher interest rates. Throw in a healthy dose of negative market headlines and you have a recipe for the increased volatility we have seen this year. Most importantly, after the strong gains of 2017 and the more "normal" market gyrations of 2018, now is an ideal time to re-evaluate tolerance for risk. It is when volatility returns with a vengeance that an investor truly learns what they can stomach.