Lowe, Brockenbrough & Company

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The Long Game

We've counseled in the last few quarterly commentaries that investors should expect lower prospective returns. You can expect good returns when valuations are low, margins are depressed and the Fed is easing. That's simply not where we are right now. The easy money's probably been made. You won't find many pundits willing to argue that point. But there's a critical time element implied that, perhaps, isn't in big enough print: **we're talking about years, not quarters**. Equity markets stumble along a path roughly marked by corporate earnings growth. It's a strong relationship, but only when viewed long-term. Quarter-to-quarter and even year-to-year, the correlation is harder to see. Perhaps 2018 will be as strong as 2017. Perhaps not. Like next month's weather, we really don't know. What we're saying is, when you look back from, let's say, five years in the future, returns will likely have been more muted. Between now and then, however, there will have been a whole lot of sunshine and rain. That's guaranteed. For sanity's sake, keep in mind it's a long game we're playing.

U.S. equity markets ended the first quarter down slightly after an exceptionally strong January. The excitement over tax reform and follow-through from last year probably spiked January higher, but the market works more like a discounting machine than a counting machine. Trump signed the pro-business bill in late December. With no better news plausibly coming, the January surge was vulnerable to a correction, which was long overdue. As traders say: sell the news. All that was needed was a spark.

That the markets were enjoying one of the longest periods of extremely low volatility on record remains a mystery. But that all ended, at least for a while, on February 2nd, with a stronger than expected employment report. Not to rehash everything we wrote in the mid-quarter piece titled The End of Goldilocks?, but the markets had become quite comfortable with moderate economic growth—not too hot, not too cold. If too hot, the Fed would need to raise rates to slow inflation; too cold, and recession risks would rise. With global economic indicators signaling the first synchronized expansion since the Great Recession, combined with tax cuts and deficit spending, investors began to fear "too hot". The 10-year Treasury note yield pushed towards 3% and stocks reacted violently. The move was juiced by a risky esoteric financial instrument that delivered gains if volatility stayed low and massive losses if it spiked. Long droughts end unexpectedly and sometimes spectacularly, and so it was with the low volatility trade. We're not sure what those folks were thinking.

After quickly falling into correction territory, equity markets spent most of February and early March recovering ground, only to be smacked down again by Trump's tariff threats to steel and aluminum producers specifically, and to the Chinese trade surplus more broadly. From our perspective, this looks like textbook Trumpian negotiating tactics: start with a growl and end with a grin. With the steel and aluminum threat, the White House first came with a broad warning, then later clarified that there could be exceptions. Trump then excluded every one of our close allies except Japan. As for China, the trade surplus is part structural and part calculated manipulation, but their measured response to Trump's threats indicates they know it's part of the show. And it could get results. Importantly, we don't believe there's much of a chance of anything worse than trade skirmishes. There is simply no empirical evidence or economic orthodoxy to support trade wars. There are cool heads in Congress; they'll find their voice, if necessary.

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The Long Game *(continued)*

Before we end, we offer a couple of thoughts on market leadership. FANG (Facebook, Apple, Netflix and Google), the cloud (Amazon, Microsoft, Intel, NVIDIA, Broadcom, etc), and a few others like Tesla, have muscled this market along over the last few years. Nearly all are counted among the most innovative and successful companies ever created, and a few are larger than anything else ever incorporated. They are the Generals. The people love the Generals, and they're heavily invested in them. Any stumbles would be unwelcome. In late March, Facebook's handling of user data came under fire. Damage control was poor—the Zuckerberg in tee shirt persona was suddenly not reassuring, and the stock quickly dropped 15%. The consequences weren't surprising. Investors lightened up on the Generals, and the first quarter's fate was sealed.

So it goes. We got a little ahead of ourselves; the 10-year Treasury note pushed up against 3%; the President's gotten around to China; and we entrusted our personal information to a multi-billionaire teenager (at least he looks like a teenager). Was there more to it than that? Maybe. It all comes back to growth. The economy's spent years underwhelming us with 2% growth. It's just not been strong enough to stir up excess, and without excess this cycle could set longevity records. But growth has improved this year and it could be durable. We'll have to see where this goes, but at the moment, things seem fairly normal, plus or minus, so we're not changing our allocations.

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