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Benjamin A. Pace is the firm's Chief Investment Officer and leader of the Investment Committee. He has more than 25 years of experience in investment management. Prior to joining Cerity Partners, he was Chief Investment Officer and Head of Global Investment Solutions for Deutsche Bank Private Wealth Management in the U.S. Ben has been featured in the Wall Street Journal and Reuters, and is a frequent commentator on Bloomberg TV and radio, Fox TV and CNBC, appearing regularly on network programs such as Power Lunch, The Closing Bell, Squawk Box, and Worldwide Exchange.

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ECONOMIC INSIGHTS | FEBRUARY 2018

We appear to be in somewhat of a "good news is bad" market environment as the stronger economic statistics and upward corporate earnings revisions are stoking fear of inflation and a spike higher in interest rates. Concerns about potential competition coming from higher yields caused another 4% gap down in US equities today on top of the similar decline on Monday. Equity markets in the US and most of the world have now experienced a 10+% correction. Besides being the first correction in the US in two years, the speed of the decline has been rather surprising.

Two fundamental issues are being cited for having precipitated today's price move. Another very robust weekly jobless claims report is causing fears of wage inflation as it appears a qualified worker shortage may be developing in certain regions and industries. Also, a disappointing 30 year Treasury bond auction provided a reminder that the burgeoning deficit due to tax reform and the prospective congressional spending plan will cause a sharp increase in Treasury bond supply over the coming year just when the Federal Reserve is reducing their purchases. Foreigners who have been aggressive purchasers of higher yielding US bonds are also purchasing less as the costs of hedging their currency exposure have increased markedly over the last year.

There were a number of Fed governors speaking today who collectively tried to downplay the economic importance of these recent equity declines. We have often said that the process of removing the extraordinary monetary ease implemented after the financial crisis would be as unprecedented as the move to 0% rates with quantitative easing was at the time. Communication mistakes by Fed members have been made a number of times since this withdrawal process began a few years ago. In fact, the previous correction of early 2016 was partially caused by the Fed Vice Chairman at the time rather confidently predicting four rate increases for the year. The volatile markets ultimately dissuaded him and his colleagues of that notion. Perhaps this recent volatility is another reminder of the caution and care which must be placed in executing this return to interest rate normalcy. The ascendancy to the Chair of Jerome Powell is somewhat of an unknown and recall that markets have tested new chairmen in the past.

Beyond the catalysts for the market decline, the magnitude of the fall has been blamed largely on the number of systematic trading strategies that use leveraged exchange traded funds to execute a portion of the trades. The ability for traders to establish a short position in market volatility has been made easier through the creation of a fund that packages the CBOE Volatility Index into a tradable vehicle. We have often wondered how some of these newer products would fare in times of market stress. As these short volatility strategies have been unwound this month, the subsequent trades appear to have exacerbated the declines in equity prices. Fortunately, the unwinding of these particular trades should be coming to an end.

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Obviously, the concern on many investors' minds is the question of whether we are currently in the midst of something more than a typical correction in a continuing bull market. Economic fundamentals continue to improve and although there may be a fear the economy is overheating, the underlying statistics point to 2018 US GDP growth of 2.75-3.00% which compares to 2.25% last year and is only slightly higher than the long term growth potential. Credit conditions remain reasonably strong as reflected in interest rate spreads for both investment grade and high yield corporate bonds remaining rather tight against comparable maturity Treasuries.

While it is always difficult to predict the end of this episode of increased market volatility, the onset of a bear market is always precipitated by an economic recession that appears some ways off considering the global strength we continue to see at this time. Of course, we will remain vigilant in our assessment of the economy with a particular eye on any damage dislocated markets themselves may inflict on the broader economy.

Please contact your Cerity Partners advisor with any questions or concerns.

Sincerely,

Ben A Pace III

Benjamin A. Pace
Chief Investment Officer