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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.

SUCCESSFUL RETEST?

ECONOMIC INSIGHTS | APRIL 2018

The recovery from the early February equity market correction was apparently a bit abrupt as the lows have been retested over the last few weeks. US equity markets lost over 2% Monday and actually traded below the February 8th correction low before recapturing half of Monday's loss at today's close. We believe this continues to be a corrective phase in an admittedly aging bull market, but the recent market action reminds us that it will be a bumpy ride as the market attempts to claw its way back.

As always, fundamental catalysts drove the price action on Monday. Over the weekend, China announced that 128 US products would be targeted in retaliation for the first round of US tariffs on Chinese steel and aluminum imports. Given the virtual guarantee of another retaliatory response to the forthcoming second round of US tariffs, directed solely at China this time, investors were reminded that protectionism and trade wars remain distinct economic and market risks.

However, the larger concern that developed throughout the day yesterday was the growing pressure on the tech sector's traditional leadership within US markets. Facebook has been under intense government scrutiny in recent weeks, following news that its customer data is being potentially misused by third party purchasers. Amazon has also come in for criticism in recent days, including from both President Trump and Senator Rubio. While there may be some political motivation, given the personal ownership of the Washington Post by Jeff Bezos, Amazon CEO, the arcane economic concept of monopsony, the control of the market by the buyer, is beginning to be applied to the company. Politicians on both sides of the aisle are calling for greater scrutiny on how the company squeezes its suppliers, including service providers such as the US Post Office.

The so-called FAANG companies (Facebook, Amazon, Apple, Netflix, Google [Alphabet]) have been important disruptors to the entrenched technology companies of the previous generation. As they have grown in size and market dominance, their future growth rates may be subject to slowing, not only through the law of large numbers, but also due to potential government regulation of all, or a portion, of their businesses. It is not readily apparent which other industry sector or subsector can step in to the breach should this market leadership be lost.

In the background of these volatility-inducing government statements and actions is the inexorable progress towards monetary policy normalization by the Federal Reserve. Rates still remain very low from an historical perspective, but the upward direction of Fed policy is a headwind to equity markets. We believe that Fed tightening may have precipitated an end to the valuation multiple expansion stage of this nearly decade-long bull market. Also, to the extent that dueling import tariffs are inherently inflationary in their first round effects, the Fed may potentially become more aggressive in its tightening stance, should higher import prices impact the broader inflation indicators.

In discussing these issues which are negatively impacting the equity markets, it is important to acknowledge the underlying strength of the US economy, which should help forestall a recession in the next couple of years. The most important of these economic tailwinds is the expected impact of the recently enacted tax reforms. Corporate tax cuts are boosting analysts' earnings and dividend growth expectations. In addition, accelerated depreciation on fixed equipment spending is encouraging corporations to boost capital expenditures to replenish their aging current capital stock. We believe much of this capital spending by corporations will be on productivity-enhancing equipment, which can offset inevitable wage increases in a tightening labor market.

Protectionism, and its ultimate extension into outright trade wars, continues to be the greatest risk to markets over the coming months, as it could lead to the premature onset of an economic recession. The progress in renegotiating NAFTA is an encouraging sign that, despite its unorthodox implementation of strategy, the US administration is interested in negotiating, as opposed to restricting, trade. First quarter earnings reporting season begins in earnest next week. Hopefully, it will reinforce that the synchronized global growth environment and increase in nominal US GDP growth is leading to an increase in the top line revenue growth rates of US corporations. Even without multiple expansion, equity price appreciation in 2018 should be able to match the growth of corporate earnings.

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

Sincerely,

Ben A Pace III

Benjamin A. Pace
Chief Investment Officer