July 30, 2018

Where Does This Road Lead?

Q2 2018 by the Numbers – YTD through June 30, 2018: the S&P 500 Index:**up 2.88%**; the Dow Jones Industrial Average: **up 0.70%**; the Vanguard FTSE All-World ex-U.S. Index: **down 3.75%**; the iShares MSCI Emerging Markets Index: **down 7.44%**; and the iShares Core U.S. Aggregate Bond Index: **down 1.64%.**

We are a little more than halfway through the fiscal year, and the U.S. economy appears to be firing on all fronts. GDP growth has the potential to exceed 4% for the second quarter, corporate earnings remain strong, unemployment is around 4%, and jobless claims are nearing levels we haven't witnessed in almost 50 years. Nonetheless, although current economic data looks good on paper, the financial markets are struggling to gain traction in 2018. So, what has investors worried?

A few things come to mind: trade disagreements, rising interest rates, and valuations, not to mention that quite frankly, this market has simply needed a breather after its 15-month post-election rally. There is one primary factor we are keeping a close eye on: the Federal Reserve's monetary-policy strategy. What the Fed does with interest rates throughout the remainder of the year has the power to undo the economic expansion we have witnessed throughout the past nine years. The Fed has implemented seven rate hikes (1.75% in total) since the end of 2015 and has telegraphed five or six more 0.25% increases for the remainder of 2018 and 2019. Although the economy is still humming along, the continuation of such monetary policy could be the headwind that upends our current market bolstered by strong earnings and corporate tax cuts.

Let's take a deeper look at this concept. When the Federal Open Market Committee (FOMC) sets the target for the federal funds rate – the rate at which banks borrow from and lend to each other – the increase has a ripple effect across the U.S. economy. Think of it this way: when the Fed increases the federal funds rate, it ultimately increases borrowing costs for consumers. Mortgages, equity lines, auto loans, credit cards, etc. are all affected. If you refinanced your home in recent years, the lower rates translated into lower payments increasing your disposable income, which for many resulted in higher consumer spending, thus benefiting the economy. The opposite is now happening as higher borrowing costs are reducing disposable income and lowering consumer spending.

The debate is this: how much can the Federal Reserve raise rates without derailing the economy? *It's a difficult question with no textbook solution. Our view is that the Fed needs to slow down and monitor the impact of the previous increases before embarking on another round of rate hikes.*

Despite this potential risk of increased rates, equities appear to have room to grow. On the subject of valuations, let's take a look at the forward PE (price to earnings) ratio of the S&P 500, one of the most common benchmarks for the market's current and future state. For context, a high forward PE ratio indicates an expensive market and a low forward PE ratio indicates a cheaper market. During the tech bubble leading into 2000, we witnessed a spike in the forward PE ratio to above 24, while during the dip in March 2009, we saw a forward PE ratio of 9 – two recent examples of volatile market extremes. In comparison, as of June 30, 2018, the forward PE ratio is 16.1, which coincidentally, matches the 25-year average for that ratio, indicating the S&P 500 is reasonably priced at its current level.

All in all, this has been a long bull run, and we are currently one month shy of breaking the record for the longest bull market in history at 113 months. While it was clear sailing in 2017, this year marks a return to the normal market ups and downs, despite the global economy continuing to grow at a strong pace. Overall, things look good right now, and the risk of recession within the next year remains low. Although there is always the potential for a longer, deeper pull-back if new risks materialize, remember that nothing has changed for long-term investors, as this year's uptick in volatility is part of a normal market cycle.

As always, we are monitoring your accounts and the markets and will keep you updated with any concerns or changes. Please do not hesitate to contact us with any thoughts or questions.

All the best,

Your AFS Team

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