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2018: More Volatility Ahead

The U.S. as well as the global economy is continuing its growth into 2018. Last year the U.S. Gross Domestic Product (GDP) grew at an annualized rate of 2.3% - not spectacular, but a far cry from the anemic 1.6% growth rate of 2016. We expect U.S. economic growth to remain strong throughout the remainder of 2018.

Reasons for optimism abound. Business confidence is soaring; consumer confidence and spending remains robust; the low jobless rate may fall further; and the global economic picture is brightening.

Now that the new tax bill is law, corporations are revising their forecasts and earnings guidance. Much has been written about this current bull market; its length has just exceeded officially nine years which makes it the second longest positive run up in history. In our opinion, the future of this bull market is unpredictable – when it will come to an end is uncertain.

Consider this: Last year only 37 stocks out of the basket of S&P 500 stocks pushed the index to record highs. In the Dow, basket of 30 stocks, only 6 stocks were responsible for most of the gain. Analysts prefer to see the market propelled higher by a larger group of stocks rather than a small number of stocks responsible for the most recent gains.

The way markets are being priced suggests there is a mismatch between expectations and reality. Stock prices are at record highs for a reason – the expectation of improving earnings growth going forward.

There are reasons to be concerned. The headwinds that can take the equity market in the opposite direction include some type of regional or global crisis involving North Korea, the Middle East or Russia for example. Domestically, the Fed’s policy of increasing interest rates seems to offer the most likely chance of stock market gains being tempered this year. A close second that is not often reported is the increasing size of our national debt.

The U.S. national debt is now at a record $20.5 trillion. The first month of fiscal year 2018 showed a deficit increase of nearly 38% from over a year ago. It seems absurd for Washington to pass a tax cut that would pile $1.5 - $1.7 trillion on top of all those accumulating deficits and debt. Tax cuts are great, but they must be at least partially offset by spending cuts. Otherwise, interest rates will spike, which will do more harm to the economy. This is especially the case when debt is more than a nation's total annual GDP.

All of this points to more volatility ahead. Last month's market correction was the first of that magnitude in over a year and a half. Corporate earnings will need to continue to grow at even a faster pace this year in order to justify the market's current historical high levels. While all events may in fact produce modest gains by the end of 2018, investors should be prepared for continued stock market volatility throughout this year.