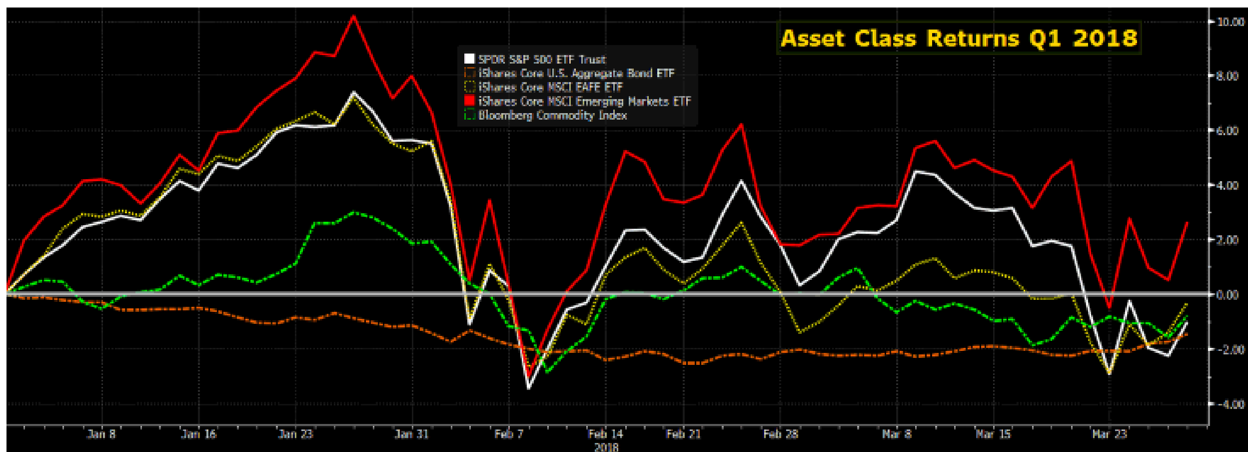
NOTTINGHAMADVISORS
ASSET MANAGEMENT

2018 First Quarter Review

Spring is the time of year when it is summer in the sun and winter in the shade.
-Charles Dickens

An investor that went to sleep on January 1st and awoke on April 1st, might easily be led to believe nothing much happened in financial markets during his or her slumber, simply by looking at return numbers. The S&P 500 lost -.75% during this timeframe, while international developed markets lost –1.6% and emerging markets gained +1.24%. Bond returns were slightly negative in Q1 while gold gained +1.7% and oil +7.7%.

Anyone paying a little closer attention (and perhaps having read our mid-February missive) will know that volatility returned with a vengeance in Q1, bringing a swift end to one of the longest periods of investor complacency that we can remember.



Source: Bloomberg

After a strong start to the year, investors grew increasingly nervous over the balance of the first quarter.

In our February letter, we suggested that the root causes of the surge in volatility weren't clear at that time. Upon further study and reflection, I'd like to suggest three main triggers for the rise in investor uncertainty: 1) fear over the possibility of a trade war with China, 2) uncertainty around the pace of future interest rate increases, and 3) our duly elected "Twitter-in-chief's" preference for chaos over order.

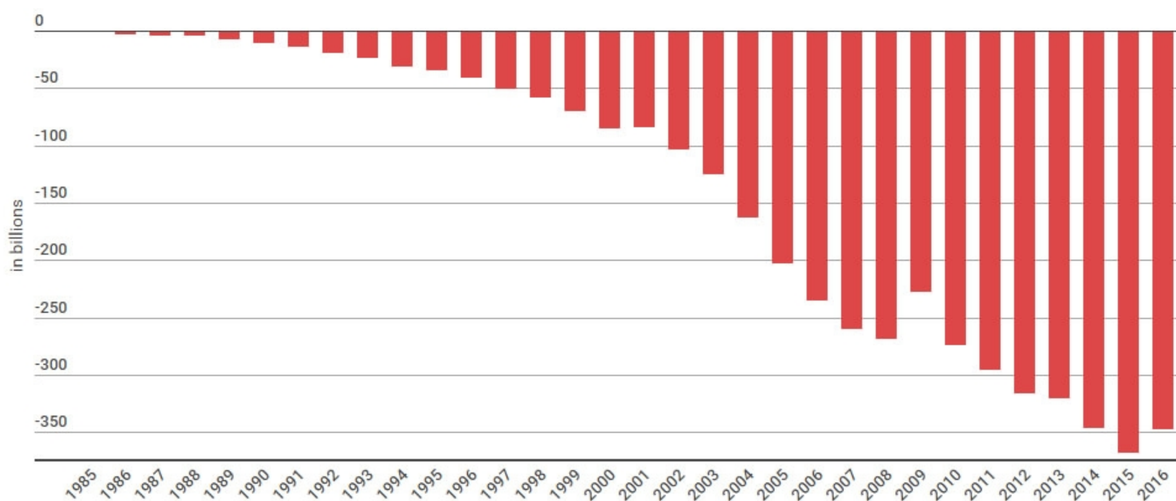
Trade

In 1817, British political economist David Ricardo developed his theory of *comparative advantage* as a way to explain why countries engage in international trade. The main idea is that even though two countries may have the same capacity to produce two goods, if each country produced only the good where they had a comparative advantage, such as low-cost labor, and then engaged in free trade, everyone would be better off in the aggregate.

Translating that into the 21st century, China has a distinct advantage over the US centered on low-cost labor. They can produce many goods far cheaper than we can here in the US. The US has a decided advantage in technology and advanced manufacturing. Although the iPhone is assembled in China, it is designed using intellectual property largely developed here in the US. For the past few decades, American consumers have

been the beneficiaries of low-cost Chinese labor. Clothing, TV sets, refrigerators, you name it, all have seen steady price declines over time as cheap labor and advances in manufacturing capability have combined to lower the cost of producing these goods.

The down-side to this has been the loss of decent paying US jobs, which have moved overseas. From textiles to manufacturing to basic tele-service positions, US companies have benefitted by moving these positions overseas. (At this point I would recommend you read JD Vance's compelling narrative Hillbilly Elegy for a better understanding of the impact this has had on rural America.) As we welcome low-cost Chinese made goods into the US, China remains a relatively closed market. Our trade deficit with China has soared, reaching -$375bn in 2017.



At the same time, China has made it difficult for US companies to access its market. Candidate Trump made this one of his main agenda items while on the campaign trail. As President Trump, he is merely following through on his promise.

While we applaud the Trump administration for having the courage to stand up to China (unlike prior administrations), we far prefer diplomacy to tariffs. Free trade has had a far greater beneficial impact on the global economy than nearly any other factor over the past 30 years. Tariffs have never advanced the cause of global growth. In the first quarter, there was a lot of tough talk by both the US and China on this issue and markets became a little unhinged at the prospect for an all-out trade war. More recently, the rhetoric has softened; however, until new trade reforms have been ironed out, this issue is likely to keep markets on edge.

Interest Rates

The Federal Reserve raised short-term interest rates .25% in March and indicated that another 2 to 3 hikes were in the offing over the balance of 2018. While interest rates are still historically low, new Fed Chair Jerome Powell's rhetoric has thus far been more hawkish than dovish. It's not so much the general direction of interest rates that is upsetting markets as much as it is the uncertainty around the potential pace of rate hikes.

Interest rates, in their simplest form, represent the cost of money. They impact decisions such as home buying, personal saving, corporate expansions and capital expenditures. Low rates can be highly simulative to an economy as the last 10 years have shown. High rates can be very restrictive (see 1982). There's an old saying, bull markets don't die of natural causes, they are murdered by the Fed. In other words, the Federal Reserve's job is to control inflation and they do that by raising interest rates when economies are strong. The US economy is strong, and the recent tax reform act should only go to increase US growth over the coming quarters.

It should come as no surprise that after 9 years of extraordinary measures (quantitative easing), the Fed is on a mission to "normalize" interest rates. This includes raising the Federal Funds rate and unwinding the $4 trillion in bonds that it added to its balance sheet since the crisis. If done right, investors shouldn't be overly concerned and should actually view it as a good thing. Past-chair Yellen was a known entity (and an avowed dove); Powell is a bit of an unknown and is believed to be slightly more hawkish. The pressure is on to "stick the landing". Only time will tell, however market interest rates will offer a useful guide.

Trump

President Trump, a true disingenue, continues to bedevil financial markets, which thrive on clarity and certainty. He seems to prefer unpredictability and disorder. Making matters worse is his penchant for communicating important messages via a 280 character tweet. On multiple occasions, his tweets have sent stocks on wild short-term rides as investors futilely try and parse his Twitter statements. For the record, we don't encourage investors to react on what is basically short-term "noise".

As always, we try and refrain from making political statements in these missives. President Obama's policies, generally speaking, were very unfriendly to corporate America, yet stock markets rose in every year of his term in office. Trump's agenda thus far (and generally speaking), has been very business friendly. After a strong year in 2017, stocks are mixed thus far in '18. Could it be that politics don't matter? Or are earnings and valuations what matter the most?

Markets

You're no doubt tired of me harping on P/E multiples and other measures of stock price value. At the end of the day, and taking in all of the above, what really matters in terms of long-term equity returns are corporate earnings and the multiple investors are willing to pay for them. By most commonly used measures of value, US stocks are expensive. <u>If, however, the companies in the S&P 500 can grow earnings 20% in 2018, as many analysts estimate, equities appear modestly attractive. Relative to bonds, equities appear decidedly attractive.</u>

Within the global equity arena, we continue to favor international stocks over domestic – partly based on better relative valuation and partly based upon more favorable economic growth prospects. Within the international equity market, we prefer emerging market stocks – with the caveat that in the event of a trade war, they will be hurt the most.

10-year Treasury yields remain stubbornly below 3.0%, despite mounting evidence of inflationary pressures building beneath the surface. Corporate spreads over treasuries remain tight, while the ratio of municipal yields to taxables indicates muni bonds are fairly valued. Despite the relative unattractiveness of bonds to stocks, investment grade debt is far less volatile and does promise the investor steady income and the repayment of principal at some future time. Those qualities should not be discounted in year 9 of a bull market.

For the past several years, Nottingham's portfolios have emphasized the low-volatility factor within our equity allocations, and the high-quality factor within our fixed-income allocations. In our eyes, the incremental cost of these biases is nominal when compared to the reduced volatility these allocations provide. This late in a bull market, we're not convinced it pays to be a hero. While our thinking and our portfolio strategies remain dynamic, we remain steadfast in our desire to minimize drawdowns during periods of market turmoil.

Summary

In some ways, the volatility we experienced in Q1 was a welcome relief. 2017 was a real anomaly in terms of the steady, relentless rise in equities. While volatility can engender investor stress, for the professional it can create market dislocations and mispricing which we enthusiastically try to identify and take advantage of for our clients. Having become more comfortable with the root causes of the markets recent liveliness, we can try and turn this to our (your) advantage via tactical trading.

As we indicated earlier, we remain bullish on stocks. Increasingly this is feeling like a real non-consensus call. The pull-back we've seen from the January highs is warranted in our eyes as the geopolitical risk premium has heightened. Now, it's up to corporate America to take advantage of lower tax rates and repatriated profits, reinvest in plant, equipment and labor, and trigger a rise in productivity. It may be a tall order to ask that it work perfectly, but we'll need a solid effort in order to get above 3% GDP growth. If successful, stocks today appear reasonably price. If we fall short, stocks are rich and will likely shed a bit of their gains. Despite rising interest rates, we think short-term bonds are still a valuable port in the storm. And, we remain convinced that well diversified portfolios will offer investors the best opportunity to grow their capital over the coming years.

Happy Spring,

Larry Whistler, CFA
President/Chief Investment Officer
April 2018

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