February 2018

Market Index	February Change	Year-to-Date
Standard & Poor's 500	-3.7%	1.8%
Dow Jones Industrial Average	-4.0%	1.7%
NASDAQ	-1.7%	5.5%
Russell 2000 (small company)	-3.9%	-1.4%
MSCI EAFE (international)	-4.5%	0.3%
Barclays Aggregate Bond Index	-1.0%	-2.1%

Monthly Update

As Volatility Returns, Stocks Snap Win Streak

The S&P 500 Index snapped a fifteen-month streak of positive total returns with a decline of nearly 4% in February. The worst damage came in the first week, when stocks dropped quickly. The 10% pullback from January 26th to February 8th ended a long stretch of calm that began in February 2016. After the quick two-week drop, the index rallied nearly 8% through February 26th. Stocks then finished the month with two consecutive days with losses of more than 1%. By month's end the index had experienced 12 trading days with moves of at least 1% in either direction, the most since January 2016.

Rising Inflation Stokes Concern; Interest Rates Creep Higher

The pullback was triggered in part by higher wage inflation readings that spooked some investors. Increasing inflation measures have also caused bond prices to fall and interest rates to rise. Rising interest rates can be a headwind to both economic activity and stock valuations. Inflation measures are still at low levels in absolute terms, coming off a decade-long period of very low inflation as a result of global recession and a slow recovery. Fears about inflation are less about the absolute level and more about the rate of increase. The faster inflation picks up, the more difficult it is for the economy and financial markets to tolerate. Faster inflation also puts great pressure on the Fed to adjust policy neither too fast nor too slow. Inflation is likely to climb further, but any fears of an inflation shock could prove to be overblown.

Upbeat Economic Outlook

While higher inflation causes concern for some, for others it is confirmation of a healthy and strengthening economic environment. Economic activity in the U.S. has been quite strong, and the positive effects of tax reform may begin to show in 2018. In addition, increased government spending is likely to provide a further boost in the near-term. The labor market has consistently improved. 2017 was the seventh-straight year the U.S. economy added at least two million jobs, the second time that has ever occurred. U.S. manufacturing output is also at levels not seen for many years.

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Monthly Update (continued)

New Fed Chairman Jerome Powell acknowledged the health of the economy in his first appearance before Congress, while also making clear his approach would be cautious and data-dependent, similar to his predecessor Janet Yellen. The market expects three or four interest rate hikes in 2018, with another three in 2019.

Strong Earnings and Share Buybacks Helped Stabilize the Market

Boosted by tax reform, corporate earnings reports have been upbeat. In fact, the fourth quarter earnings season has been one of the best on record. More than half of companies exceeded consensus expectations for earnings per share, the highest since 2010. In addition, more than half of companies have far exceeded expectations for revenues, the highest percentage since 2004. Fourth-quarter earnings per share are on pace to be 15% higher on a year-over-year basis, and the full-year growth rate of 12% is the fastest since 2011. Earnings per share grew in every sector in 2017, and all sectors grew revenues except telecom. Earnings are expected to grow by 18% in 2018. That growth rate received a significant boost with the passage of the Tax Cuts and Jobs Act in late December, but is also a result of a solid economic backdrop, higher oil prices, a weaker dollar, and higher interest rates. Companies have also been buying back their own shares at a rapid clip, which boosts stock prices and earnings per share.

President Trump Imposes Tariffs on Steel and Aluminum Imports

On the first day of March Trump followed through on a long-standing promise to take action on trade policy. Throughout the campaign in 2016 and his first year in office the President made clear he intended to strike back at other nations for trade policies that hurt the U.S. The issue took a back seat for much of 2017 as tax reform was front-and-center. At a White House meeting with executives from steel and aluminum companies, Trump announced that he will impose tariffs on imports of those two commodities. He indicated that steel tariffs would be 25% and aluminum tariffs would be 10%. While much of Trump's commentary focused on China, these tariffs would affect a wide group of countries. The announcement triggered responses from several countries that pledged to defend their interests and workers in those industries with actions of their own. It will take some time to determine the ultimate effects of the tariffs and other changes to trade policy that may come. In the short run, there are clear winners (domestic steel and aluminum companies) and losers (exporters of steel and aluminum to the U.S.). But over the long run, the outcome is less clear. Either way, the back and forth "trade war" rhetoric could generate further market volatility. These headlines may drive stock market action in the short term, but the ultimate impact to the stock market will be driven by the actual economic impact over time.

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